

TRANSCRIPT OF RECORD.

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1922.

No. 724.

**ATLANTIC COAST LINE RAILROAD COMPANY,
APPELLANT,**

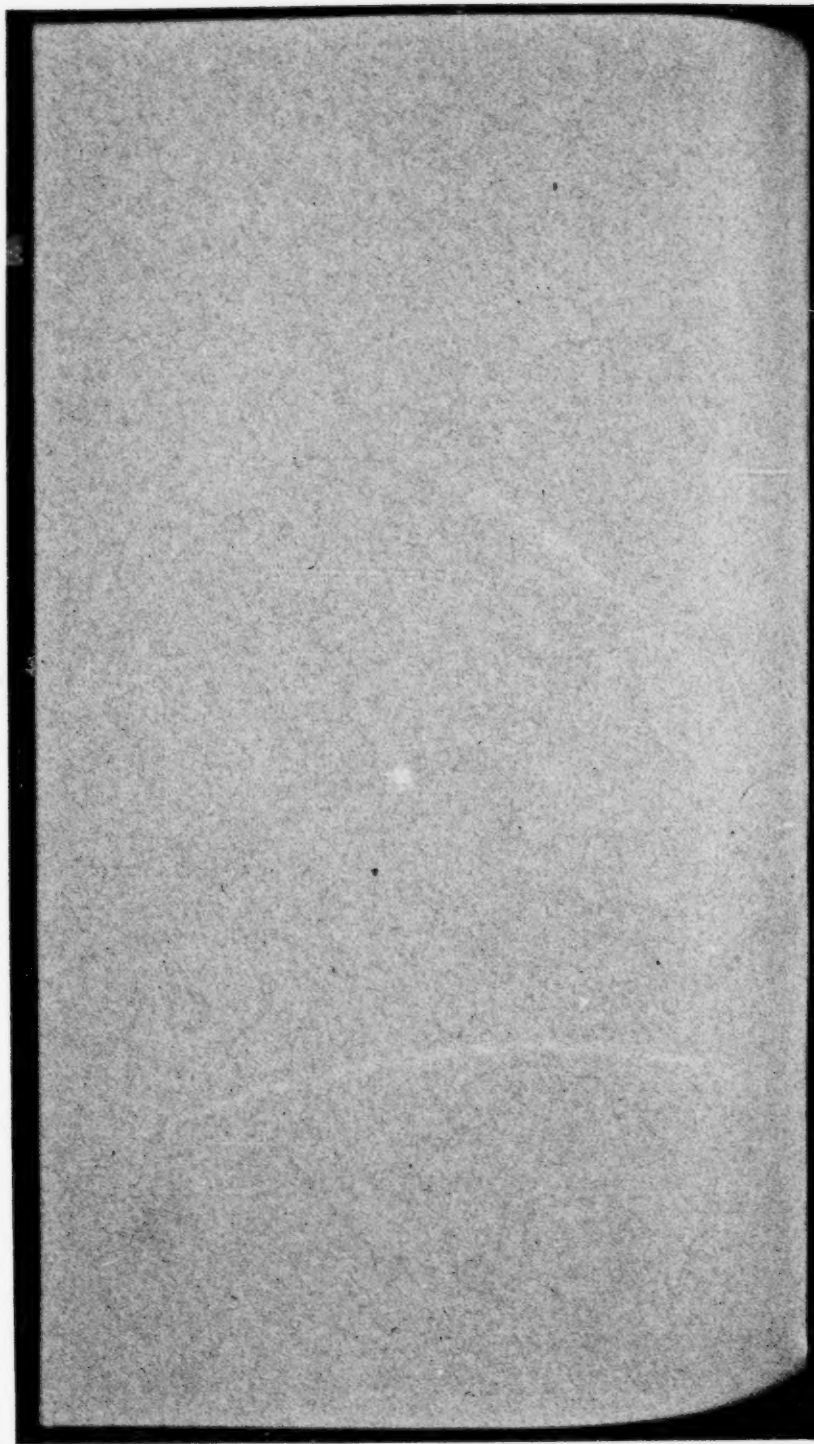
vs.

**A. D. WATTS, COMMISSIONER OF REVENUE OF THE
STATE OF NORTH CAROLINA, ET AL.**

**APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR
THE EASTERN DISTRICT OF NORTH CAROLINA.**

FILED DECEMBER 9, 1922.

(29,274)



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TRANSCRIPT OF RECORD.

In the District Court of the United States for the Eastern District of North Carolina.

At a District Court of the United States for the Eastern District of North Carolina begun and held at the court-house, in the city of Raleigh, on the fourth Monday after the fourth Monday in October, being the 20th day of November, in the year of our Lord one thousand nine hundred and twenty-two.

Present: The Honorable Henry G. Connor, Judge of the District Court for the Eastern District of North Carolina.

Among others were the following proceedings, to-wit:

In Equity.

ATLANTIC COAST LINE RAILROAD COMPANY

vs.

A. D. WATTS, Individually and as Commissioner of Revenue of North Carolina, et al.

Bill of Complaint.

Filed Mar. 31, 1922.

In the United States District Court for the Eastern District of North Carolina.

In Equity.

No. 448.

ATLANTIC COAST LINE RAILROAD COMPANY, Complainant,

vs.

A. D. WATTS, Individually and as Commissioner of Revenue of North Carolina; Benjamin R. Lacy, State Treasurer of North Carolina; Baxter Durham, State Auditor of North Carolina; James S. Manning, Attorney General of North Carolina, and Frank Nash, Assistant Attorney General of North Carolina, Defendants.

To the Honorable H. G. Connor, Judge of the District Court of the United States for the Eastern District of North Carolina:

The Atlantic Coast Line Railroad Company, a corporation duly organized, created and existing under and by virtue of the laws of the State of Virginia, and a citizen and resident of said State, brings this its Bill of Complaint against A. D. Watts, Individually and as

Commissioner of Revenue of North Carolina, a citizen of the State of North Carolina, whose individual residence is in the County of Iredell in said State, and in the Western District thereof, and

whose official residence as Commissioner of Revenue of North Carolina is at the City of Raleigh in said State, and in the

Eastern District thereof; Benjamin R. Lacy, Treasurer of the State of North Carolina, and a citizen and resident of the County of Wake, in the Eastern District of said State, Baxter Durham, Auditor of the State of North Carolina, and a citizen and resident of the County of Wake, in the Eastern District of said State; James S. Manning, Attorney General of the State of North Carolina, and a citizen and resident of the County of Wake, in the Eastern District of said State, and Frank Nash, Assistant Attorney General of the State of North Carolina, a citizen of the State of North Carolina, whose individual residence is in the Town of Hillsboro in said State, and in the Western District thereof, and whose official residence as Assistant Attorney General of North Carolina is at the City of Raleigh in said State and in the Eastern District thereof.

And thereupon complainant complains and prays:

1. That the complainant was at all times hereinafter mentioned and is now, a corporation duly created, organized and existing under and by virtue of the laws of the State of Virginia, and is a citizen of said State, and is not a citizen of the State of North Carolina, and that it did at all times hereinafter mentioned, and does now, operate, lease and control lines of railroad and other property in and through the States of Virginia, North Carolina, South Carolina, Georgia, Florida and Alabama, and is now and was at all such times operating said lines of railroad in interstate commerce. The total mileage of road so operated, owned, leased and controlled by the complainant as of May 1, 1921, in the State of North Carolina, and elsewhere, was 4,889.76 miles, and the total miles of road, operated, owned, leased or controlled by complainant as of said date was distributed between mileage in the State of North Carolina and outside of the State of North Carolina (by separate lines, divisions and branches), as is shown in the following statement:

4	Virginia	147.29
	North Carolina	1,043.79
	South Carolina	929.41
	Georgia	725.95
	Florida	1,791.62
	Alabama	251.70
	Total	4,889.76

The ratio of proportion which the length of the lines leased, operated or controlled in North Carolina bore to the total length of miles operated, owned, leased or controlled in the State of North Carolina and elsewhere was .21316 per cent.

2. That the defendant A. D. Watts is Commissioner of Revenue of North Carolina, duly appointed by the Governor of North Caro-

lina, and under and by virtue of Chapter 40 of the Public Laws of North Carolina of 1921, and duly qualified under the laws of said State and is a citizen of the State of North Carolina, whose individual residence is in the County of Iredell in said State, and in the Western District thereof, and whose official residence as Commissioner of Revenue of North Carolina is at the City of Raleigh, in said State, and in the Eastern District thereof; that the defendant Benjamin R. Lacy is the State Treasurer of the State of North Carolina, duly elected and qualified under the laws of the said State and is a citizen and resident of the County of Wake in the Eastern District of said State; that the defendant Baxter Durham is the State Auditor of the State of North Carolina and is a citizen and resident of the County of Wake, in the Eastern District of said State; that the defendant James S. Manning is Attorney General of the State of North Carolina and a citizen and resident of the County of Wake, in the Eastern District of said State; that the defendant Frank Nash is Assistant Attorney General of the State of North Carolina, and is a citizen of the State of North Carolina, whose individual residence is in the Town of Hillsboro, in the said State, and in the Western District thereof, and whose official residence as Assistant Attorney General of the State of North Carolina is in the City of Raleigh in said State, in the Eastern District thereof.

3. That this is a suit in equity and arises under the laws and Constitution of the United States, as will hereinafter particularly appear, and the amount in controversy in this case, exclusive of interest and cost, as will be more specifically shown, exceeds the sum and value of three thousand dollars (\$3,000.00). Among other things this suit is brought to redress and prevent the deprivation under color of the several statutes of North Carolina of certain rights and immunities secured to the complainant by the Constitution of the United States—that is, the right to have and enjoy its property without being deprived thereof without due process of law, and without being denied the equal protection of the law, and this suit involves the further question as to whether certain taxes sought to be made and imposed upon complainant under color of the several statutes of the State of North Carolina interfere with, burden, obstruct and regulate commerce with the foreign nations and among the several states and taxes the property of this complainant outside of the State of North Carolina in contravention of the Constitution of the United States and the Fourteenth Amendment and commerce clause thereof,

4. The complainant shows that the provisions of the Constitution of North Carolina, Article 5, Section 3, authorizing the levy of an income tax on itself and other railroad corporations are as follows:

"Taxation shall be by uniform rule and ad valorem

Exemptions.—Laws shall be passed taxing, by a uniform rule, all moneys, credits, investments in bonds, stocks, joint stock companies, or otherwise; and, also, all real and personal property, according to

its true value in money: Provided, notes, mortgages, and all other evidence of indebtedness given in good faith for the purchase price of a home, when said purchase-price does not exceed three thousand dollars, and said notes, mortgages, and other evidence of indebtedness shall be made to run for not less than five nor more than twenty years, shall be exempt from taxation of every kind: Provided, that the interest carried by such notes and mortgages shall not exceed five and one-half per cent. The general assembly may also tax trades, professions, franchises, and income: Provided, the rate of tax on incomes shall not in any case exceed six per cent (6%) and there shall be allowed the following exemptions, to be deducted from the amount of annual incomes, to wit: for a married man with a wife living with him, or to a widow or widower having minor child or children, natural or adopted, not less than \$2,000; to all other persons not less than \$1,000, and there may be allowed other deductions (not including living expenses) so that only net incomes are taxed."

5. The complainant shows that the Legislature of North Carolina, at its regular session in 1921, purporting to act under the authority of the provision of the Constitution above quoted, enacted a law providing for the levying, collecting and paying of an income tax on individuals and corporations, the said law forming a part of the Revenue Act of 1921, being Chapter 34 of the Public Laws of North Carolina of 1921. It is provided by Section 100 of said Revenue Act that the income tax schedule should be known and cited as the Income Tax Act of 1921, and said Act will be so referred to in this bill of complaint.

6. Section 101 of the Income Tax Act of 1921, as amended by the General Assembly of North Carolina, special session of 1921, is as follows:

"Sec. 101. Purpose.—The general purpose of this act is to impose a tax, for the use of the State Government, upon the net income for the calendar year 1921, in excess of exemptions herein set out, collectible in the year 1922, and annually thereafter:

(a) Of every citizen of the State;

(b) Of every domestic corporation;

7 (c) Of every foreign corporation and of every non-resident individual having a business agency in this State, in proportion to the net income of such business or agency.

Except as otherwise provided in this act the purpose is to conform to the definition of income in the revenue laws of the United States Government and regulations made under its authority, in so far as they apply.

The tax imposed upon the net income of corporations in this schedule is in addition to the tax imposed under Schedule C of this act."

7. Section 201 of the Income Tax Act of 1921, as amended by the General Assembly of North Carolina, Special Session of 1921, is as follows:

"Sec. 201. Corporations. Every corporation organized under the laws of this State shall pay annually an income tax equivalent to three per cent of the entire net income of such corporations as herein defined, received by such corporation during the income year; and every foreign corporation doing business in this State shall pay annually an income tax equivalent to three per cent of a proportion of its entire net income, to be determined according to the following rules:

"In case of a company other than companies mentioned in the next succeeding section, deriving profits principally from the ownership, sale, or rental of real estate, or from the manufacture, sale or use of tangible personal property, such proportion of its entire net income as the fair cash value of its real estate and tangible personal property in this State on the date of the close of the fiscal year of such company in the income year is to the fair cash value of its entire real estate and tangible personal property then owned by it, with no deduction on account of encumbrances thereon.

"In case of a corporation deriving profits principally from the holding or sale of intangible property, such proportion as its gross receipts in this State for the year ended on the date of the close of its fiscal year next preceding is to its gross receipts for such year within and without the State."

8. Section 202 of the Income Tax Act of 1921 is as follows:

"Sec. 202. Railroads and Public Service Corporations.—The basis of ascertaining the net income of every corporation engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, shall be the 'net operating income' of such corporation as shown by their records kept in accordance with that standard classification of accounts, when their business is wholly within this State, and when their business is in part within and in part without the State their net income within this State shall be ascertained by taking their gross 'operating revenues' within this State, including in their gross 'operating revenues' within this State the equal mileage proportion within this State of their interstate business and deducting from their gross 'operating revenues' the proportionate average of 'operating expenses,' or 'operating ratio,' for their whole business as shown by the Interstate Commerce Commission standard classification of accounts. From the net operating income thus ascertained shall be deducted 'uncollectible revenue,' and taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes, and the balance shall be deemed to be their net income taxable under this act."

9. The foregoing section relating to the basis of ascertaining the net income of railroads was supplemented by Chapter 35 of the Public Laws of 1921, as follows:

9 "Section 1. That in determining the taxable income of a corporation engaged in the business of operating a railroad under section two hundred and two of the act to raise revenue, in the case of a railroad located entirely within this State, the net operating income shall be increased or decreased to the extent of any credit or debit balance received or paid, as the case may be, on account of car hire; and when any railroad is located partly within and partly without this State, then said net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid, as the case may be, on account of car hire."

10. Section 203 of the Income Tax Act of 1921, as amended by Chapter 35, Public Laws of 1921, is as follows:

"Sec. 203. Such tax shall first be levied, collected, and paid in the year 1922, and with respect to the net income received during the calendar year 1921 and annually thereafter."

11. Section 3 of Chapter 34, Public Laws of 1921, provides:

"No tax on any property in the State shall be levied for any of the uses of the State Government. The taxes hereinafter levied in this act are for the expenses of the State Government, the appropriations to its educational, charitable, and penal institutions, pensions for Confederate soldiers and widows, the interest on the debt of the State, an equalizing fund for public schools, and other specific appropriations made by law, and shall be collected and paid into the general fund of the State Treasurer."

12. Complainant shows that the said Income Tax Act of 1921 is unconstitutional and void in its application to complainant and other railroads for the following reasons:

(a) For that it is not a tax on income as authorized in Article 5, Section 3, of the Constitution of North Carolina, but is in truth and in fact a tax upon operating revenue derived by railroad companies from interstate and intrastate commerce, and for the reason that from the operating revenue arrived at under the said law there are not allowed many of the deductions required by the Standard Classification of Accounts of the Interstate Commerce Commission which Standard Classification of Accounts was promulgated by the said Interstate Commerce Commission under the provisions of the Interstate Commerce Act passed by Congress, and which are so regulated as to ascertain what is the net income of railroads engaged in interstate commerce. Complainant says that among other items which are directed to be deducted by railroads in interstate commerce from operating income, in order to arrive at net income, are the following:

Joint facility rents,
Rent from leased roads,
Miscellaneous rents,
Miscellaneous tax accruals,
Separately operated properties—loss,
Interest on funded debt,
Interest on unfunded debt,
Amortization of discount on funded debt,
Maintenance of investment organization,
Income transferred to other companies,
Miscellaneous income charges.

and avers that in order to ascertain the net income of railroad companies engaged in business in interstate commerce, as complainant is, according to said Standard Classification of Accounts of the Interstate Commerce Commission, promulgated as aforesaid, it is necessary to deduct the above items.

(b) The method of arriving at net income does not result in the ascertainment of net income as the same is defined and arrived at under the Standard Classification of Accounts of the Interstate Commerce Commission, in that the Standard Classification of Accounts directs that there shall be deducted from the net operating income not only the deductions provided for in said law of North Carolina, but in addition thereto the following:

Joint facility rents,
Rent from leased roads,
Miscellaneous rents,
Miscellaneous tax accruals,
Separately operated properties—loss,
Interest on unfunded debt,
Interest on funded debt,
Amortization of discount on funded debt,
Maintenance of investment organization,
Income transferred to other companies,
Miscellaneous income charges.

The result is that the machinery provided for by the said statute for the ascertainment of net income does not in truth and in fact produce net income, which under Section 101 is declared to be the purpose of the said act to tax. Furthermore, the method outlined in said law for arriving at net income produces a figure which is not the true net income, but which contains in part gross income, and insofar as it does include gross income, which gross income is derived from interstate commerce, said tax is a direct burden upon interstate commerce and is void under the Commerce Clause of the Constitution of the United States.

(c) Complainant further says that the statute is unconstitutional and void for that by Section 306 it permits corporations other than the corporations named in Section 202 to deduct:

(1) All the ordinary and necessary expenses paid during the income year in carrying on any trade or business, including:

(a) As to individuals, wages of employees for services actually rendered in producing such income.

(b) As to partnerships, wages of employees and a reasonable allowance for co-partners or members of a firm for services actually rendered in producing such income, the amount of such salary allowance to be included in the personal return of the co-partner receiving same.

(c) As to corporations, wages of employees and salaries of officers, if reasonable in amount, for services actually rendered in producing such income.

(2) Rentals or other payments required to be made as a condition of the continued use or possession, for the purposes of the trade or property to which the taxpayer has not taken or is not taking title or in which he has no equity.

(3) All interest paid during the income year on indebtedness except interest on obligations contracted for the purchase of non-taxable securities. Dividends on preferred stock shall not be deducted as interest.

(4) Taxes for the income year, except taxes on income and war profits and excess profits taxes, inheritance taxes, and taxes assessed for local benefit of a kind tending to increase the value of the property assessed.

(5) Dividends from stock in any corporation, the income of which shall have been assessed and the tax on such income paid by the corporation under the provisions of this act; Provided, that when only part of the income of any corporation shall have been assessed under this act only a corresponding part of the dividends received therefrom shall be deducted.

(6) Losses sustained during the income year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit.

(7) Debts ascertained to be worthless and charged off within the income year, if the amount has previously been included in gross income in a return under this act.

(8) A reasonable allowance for the depreciation and obsolescence of property used in the trade or business; and, in the cases of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion: Provided, that, in computing the deductions allowed under this paragraph, the basis shall be the cost (including in the case of mines, oil and gas wells, and other natural deposits, the cost of development, not otherwise deducted), and in the case of property acquired prior to January 1st, 1921, the fair market value of the property (or the taxpayer's

interest therein) on that date shall be taken in lieu of cost up to that date. The reasonable allowances under this paragraph shall be made under rules and regulations to be prescribed by the Tax Commission. In the case of leases the deductions allowed may be equitably apportioned between the lessor and lessee.

(9) In the case of taxpayers who keep regular books of account, upon an accrual basis, and in accordance with standard accounting practice, reserves for bad debts and for contingent liabilities, under such rules and restrictions as the Tax Commission may impose. If the Tax Commission shall at any time deem the reserve excessive in amount, it may restore such excess to income, either in a subsequent year or as a part of the income of the income year and assess it accordingly.

(10) Contributions or gifts made within the taxable year to corporations or associations operated exclusively for religious, charitable, scientific or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, to an amount not in excess of fifteen per centum of the taxpayer's net income as computed without the benefit of this subdivision.

(11) Resident individuals having an established business in another State, or investment in property in another State, may deduct the net income from such business or investment, if such business or investment is in a State that levies a tax upon such net income. The deduction authorized in this subsection shall in no case extend to any part of income of resident individuals from personal services, or mortgages, stocks, bonds, securities and deposits.

14 (12) In the case of a non-resident individual, the deductions allowed in this section shall be allowed only if, and to the extent, that, they are connected with income arising from sources within the State; and the proper apportionment and allocation of deductions with respect to sources of income within and without the State shall be determined under rules and regulations prescribed by the State Tax Commission.

13. The said Income Tax Act of 1921, in violation of the Constitution of North Carolina and the Constitution of the United States, creates a discrimination against the complainant and other railroad companies of similar character in favor of other corporations and individuals in that said act in order to ascertain the taxable income allows other corporations and individuals certain deductions, set out in paragraph 12, many of which said deductions are not allowed to complainant and other railroad corporations of similar character, and all of which are deductions which must be made in order properly to determine net income.

14. Complainant shows that under the provisions of the Income Tax Act of 1921, and particularly Section 202, Section 300, and Section 306, all corporations, except railroads and public service cor-

porations, which are required to keep records according to the Standard Classification of Accounting of the Interstate Commerce Commission, are required to pay a tax on their net income, which is defined by Section 300 as "the gross income of a taxpayer, less the deductions allowed by this act," whereas complainant and other railroads and public service corporations, which are required to keep records according to the Standard Classification of Accounting of the Interstate Commerce Commission, are not allowed the deductions set forth in the said Act, except "uncollectible revenue," and taxes paid in the State for the income year, other than income taxes, war profits and excess profits taxes, and certain deductions for car hire, and complainant shows that it, and other railroad companies and public service corporations of similar character referred to in Section 202 of the Income Tax Act of 1921 are denied large deduc-

15 tions which are granted other railroads, corporations and individuals, and particularly the deduction of interest paid during the income year, which results in discrimination against the complainant in violation of the Constitution of North Carolina, and "denies the complainant the equal protection of the law and deprives it of its property without due process of law in contravention of the Fourteenth Amendment to the Constitution of the United States."

15. Complainant shows that the said Income Tax of 1921 does not operate equally and uniformly upon all taxpayers in similar circumstances, and that the complainant and other railroads and public service corporations, which are required to keep records according to the Standard Classification of Accounting of the Interstate Commerce Commission, have been arbitrarily selected and taxed upon a more burdensome basis and one that is different from that applied to corporations in general, and to other corporations engaged in business similar to that of complainant in violation of the Constitution of North Carolina, and "denies the complainant the equal protection of the law and deprives it of its property without due process of law in contravention of the Fourteenth Amendment to the Constitution of the United States."

16. Complainant shows that the income tax levied by the said Income Tax Act of 1921 is not levied by a uniform rule as required by the Constitution of North Carolina, Article 5, Section 3, and the lack of uniformity works greatly to the detriment of complainant, in violation of said Article 5, Section 3, of the Constitution of North Carolina, and "denies the complainant the equal protection of the law and deprives it of its property without due process of law in contravention of the Fourteenth Amendment to the Constitution of the United States."

17. Complainant shows that the classification of taxpayers for the purpose of fixing the income on which the tax shall be paid as made by the said Income Tax Act of 1921 is not based upon any reasonable ground, but is a mere arbitrary selection, so far as the cor-

16 porations set forth in Section 202 are concerned, and was made for the purpose and has the result of imposing upon

such corporations, including complainant, an unjust burden of taxation, in violation of the Constitution of North Carolina and denies the complainant the equal protection of the law and deprives it of its property without due process of law, in contravention of the Fourteenth Amendment to the Constitution of the United States."

18. Complainant shows that the method of fixing its taxable income as provided by Section 202 of the said Income Tax Act of 1921 violates the Constitution of North Carolina, and the Constitution of the United States, because it does not apply to railroads and public service corporations which derive their income from sources other than the operation of their property, which results in a lack of uniformity in the application of the income tax and in discrimination against complainant, and therein "denies the complainant the equal protection of the law and deprives it of its property without due process of law, in contravention of the Fourteenth Amendment to the Constitution of the United States."

19. Complainant shows that the tax imposed upon complainant by Section 202 of the Income Tax Act of 1921 is unconstitutional and void because the authority of the Legislature of North Carolina to tax incomes is derived from Section 3, Article 5, of the Constitution of North Carolina, and said section provides that only net incomes may be taxed, and in attempting to tax the "operating revenues" of complainant, the said Act violates the Constitution of North Carolina, and "denies complainant the equal protection of the law and deprives it of its property without due process of law, in contravention of the Fourteenth Amendment to the Constitution of the United States."

20. Complainant further shows that the statute is violative of Article 5, Section 3, of the Constitution of North Carolina, for that it does not levy upon railroads and other public service corporations named in said Section 202, a tax on net income, but levies a tax upon operating revenue derived from interstate and intrastate commerce, and does not permit the deductions necessary and incidental to the business of complainant, and expended by it from said income in order to determine net income, and is in violation of the interstate commerce clause Section 8, Article 1 of the Constitution of the United States in that it permits a tax as an income tax to be placed on gross income derived from interstate commerce, thereby directly burdening interstate commerce.

21. Complainant shows that the Income Tax Act of 1921 violates the Transportation Act of Congress and the Interstate Commerce Act, in that it seeks to prescribe a method of accounting by this interstate carrier, when said Acts of Congress have delegated the power to prescribe said accounting to the Interstate Commerce Commission, and the said Commission has prescribed and directed that the complainant, and other interstate carriers, keep their accounts in accordance with the methods prescribed by it.

22. Complainant shows that the State of North Carolina, by its tax laws, permits the counties, cities, towns, townships and special taxing districts to levy on the assessed value of complainant's property known as an ad valorem tax, which is based upon the whole property of complainant, tangible and intangible, and to this the tax laws of the State adds a so-called franchise tax of one-tenth of one per cent. on the same assessed value, and by the statutes hereinbefore referred to, the Legislature of North Carolina has levied, and unless restrained, the defendants in this action will undertake to collect an additional tax characterized as an income tax of three per cent on complainant's net operating revenue, including revenue derived from interstate commerce, and complainant avers that this system of pyramiding taxes, and the entire scheme of taxation, amounts to a regulation of commerce between the states, because, necessarily, a tax of one-tenth of one per cent upon the tangible and intangible property of this complainant, and a tax of three per cent upon its net operating revenue, including revenue derived from interstate commerce, are taxes upon interstate commerce, the property, tangible and intangible, having already been taxed at its full value, and complainant shows that this scheme of taxation levies a tax and burden upon the interstate commerce of complainant, and violates the commerce clause of the Constitution of the United States. Section 8, Article 1.

23. Complainant further shows that the statutes imposing an income tax upon complainant are unconstitutional and void in that they are violative of the scheme of taxation created and made mandatory by the Constitution of North Carolina. That instrument provides a dual system of taxation, one set of taxes being leviable by the State, and the other by the counties and other governmental subdivisions. The complainant, therefore, avers that the scheme of taxation brought about by the tax laws of North Carolina, whereby the State derives its entire revenue from taxes other than a tax on property is unwarranted by the Constitution of North Carolina, which, by its mandate, requires that all property shall bear its just proportion of the burden of taxation, and that laws shall be passed taxing by a uniform rule all moneys, credits, investments in bonds, stocks, joint stock companies, or otherwise, and also all real and personal property according to its true value in money, (Article 5, Section 3), and the complainant shows that the North Carolina Legislature has no power to exempt a large class of property from liability to taxation for state purposes, as is done by Section 3, Chapter 34, Public Laws of 1921, and recoup the loss of revenue thereby occasioned by taxation other than a tax on property. Such method or scheme of taxation is plainly at variance with that intended to be established by the Constitution of North Carolina, and, consequently,

19 Section 202, which attempts to impose a part of this additional burden of taxation upon the complainant, is void, in that it violates the Constitution of North Carolina, and denies the complainant the equal protection of the law and deprives the complainant of its property without due process of law in violation of the Fourteenth

Amendment to the Constitution of the United States, and complainant further shows that the said scheme of taxation is unconstitutional and void, in that the complainant is charged with an undue proportion of the expenses of the State government, and a greater proportion of the burden of taxation than is warranted by the Constitution of North Carolina, in that complainant is required by the tax laws of North Carolina to pay to counties, cities and towns, and special tax districts, large sums as taxes on the assessed value of its property, and in addition thereto, a so-called franchise tax of one-tenth of one per cent on its assessed value of \$51,163,717.00, and the income tax of three per cent on its net operating revenue.

24. Complainant further shows that said tax for the calendar year 1921 is unconstitutional and void because it is retroactive to the extent that it attempts to tax income for the months of January, February, and eight days in the month of March, 1921, the said Act having been ratified March 8th, 1921, and being effective from and after its ratification.

25. Complainant shows that a form for the income tax return for the calendar year ending December 31st, 1921, has been received by complainant, which requires said return to be made in conformity with the provisions of Section 202 of the Income Tax Act of 1921, and complainant is required by law to file said return with the Commissioner of Revenue on or before March 15th, 1922, and said return, as required by said form, will show \$1,389,565.09 as the amount on which complainant will be taxed at the rate of three per cent (3%), and the tax which the complainant will be required to pay to the State of North Carolina on or before March 15th, 1922, is \$41,686.96, whereas the true income of the complainant for the calendar year ending December 31st, 1921, is \$333,205.09, and whereas the said tax if paid upon the true net income, according to the Standard Classification of Accounts of the Interstate Commerce Commission, or according to any other method which would result in net income, is \$9,996.15, and unless the defendants are restrained and enjoined from doing so, they will proceed on or after March 15th, 1922, to assess said tax and collect the same from complainant. It is further shown that under the laws of North Carolina, the said tax will become a lien upon the property of complainant, and will be a cloud upon its title, and the enforcement of said tax by execution would interfere with the conduct of complainant's business as an interstate carrier, and it is further shown that, upon the collection of said tax, the amount thereof will pass into the Treasury of the State of North Carolina, and the complainant is without remedy by which it can obtain refund thereof, all to the irreparable damage of complainant, and for which it has no adequate remedy at law. Plaintiff attaches hereto a copy of the report upon the form which it will be required to make to the said Commissioner of Revenue, as Exhibit A, and a statement showing the correct net income, as Exhibit B.

26. Complainant shows that Section 600 of the said Income Tax Act of 1921 imposes certain penalties upon a taxpayer who fails to pay

any taxes levied by the said act, said penalties, among other things being double the amount of the taxes. Complainant avers that said penalties are excessive, unreasonable, oppressive and inequitable; that it is a denial of the due process of law for the said act to impose said penalties upon the complainant who is proceeding with due diligence to have it judicially determined whether or not said act is valid, the complainant in good faith asserting that said act is not valid. The complainant therefore avers that even though the said act should finally be declared valid the said penalties ought not to be imposed upon the complaint.

21

Prayer.

Wherefore, and for as much as Complainant is remediless in the premises, according to the common law, and remediable only in equity, and that complainant may not be subjected to the many penalties provided by the said laws, and may not suffer irreparable injury and damage, and may not have its property taken from it without due process of law, may not be denied the equal protection of the laws, and may carry on its business untrammelled by the burdens imposed by the laws of North Carolina, may be permitted to pursue and carry on its business without unlawful hinderance and destruction, and that the railroad operated by complainant in the State of North Carolina as aforesaid, and its property may not be subjected to illegal liens, complainant prays for a writ of subpoena to issue against the defendants and each and every one of them named and described as aforesaid to appear and full and true answer make to this bill of complaint, but not under oath, answer under oath being waived, and that said defendants, and each and every one of them, be enjoined by final decree, and meanwhile, by a preliminary injunction, as follows, to wit:

That said A. D. Watts, Commissioner of Revenue of North Carolina, be enjoined and restrained from taking, or causing to be taken, any action toward enforcing the tax or penalties, or any part thereof, which the said Income Tax Act of 1921 imposes upon the complainant or its property within the State of North Carolina.

That Baxter Durham, as Auditor of North Carolina, be enjoined and restrained from charging to complainant for collection, and that Benjamin R. Lacy, as State Treasurer, be enjoined and restrained from collecting from complainant the tax or any part thereof imposed by said act.

That James S. Manning, as Attorney General of North Carolina, and Frank Nash, as Assistant Attorney General of North Carolina, be enjoined and restrained from instituting or authorizing the institution of any suit or proceedings to collect the said tax or penalties.

Complainant further prays that the tax statutes of North Carolina herein alleged to be unlawful be decreed by this court to be unconstitutional and invalid, and that no assessment for taxation be made against the complainant thereunder, and no tax be levied against or collected from the complainant thereunder; and for all

such other, further, general and special relief to which in equity it may be entitled.

This is the first application for an injunction in this cause.

THOMAS W. DAVIS,
Solicitor for Complainant.

GEORGE B. ELLIOTT,
SKINNER & WHEDBEE,
Of Counsel.

STATE OF NORTH CAROLINA,
County of New Hanover:

R. D. Cronly, being duly sworn, deposes and say that complainant, Atlantic Coast Line Railroad Company is a corporation, and that he is one of its officers, to wit, Assistant Secretary; that he has read the foregoing bill of complaint and knows the contents thereof; that the same is true of his own knowledge, except as to those matters therein set forth on information and belief, and as to those matters he believes it to be true.

R. D. CRONLY. [L. S.]

Sworn to and subscribed before me this the 10th day of March, 1922.

[SEAL.]

B. B. REYNOLDS,
Notary Public.

My commission expires January 31st, 1924.

EXHIBIT "A" TO BILL.

State Department of Revenue.

Public-Service Corporation Income Tax Returns.

(Railroads.)

For Calendar Year Ending December 31, 1921.

Name, Atlantic Coast Line Railroad Company.
Business address, Wilmington, N. C.

We, the undersigned, president and treasurer of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return, including the accompanying schedules and statements, has been examined by him and is, to the best of his knowledge and belief, a true and complete return made in good faith, for the taxable period as stated, pursuant to the Revenue Act of 1921 and the Regulations issued under authority thereof.

President.

Treasurer.

Sworn to and subscribed before me this — day of —, 1922.

(Official capacity.)

*Net operating income (when business is wholly within the State).....	
*Net operating revenue, including equal mileage proportion within this State of the interstate business (when business is in part within and in part without the State).....	\$16,561,435.11
Other income.....	
Total income.....	\$16,561,435.11
*Operating expenses (when business is wholly within the State).....	
*Proportionate average of operating expenses (when business is in part within and in part without the State).....	\$14,596,266.11
*Uncollectible revenue.....	20,518.08
Taxes paid in this State, other than income and war profits and excess profits taxes.....	458,290.43
Total deductions.....	\$15,075,074.62
Operating income, less deductions.....	\$1,486,360.49
Plus or Minus any credit or debit balance received or paid on account of car hire. And when any railroad is partly within and partly without the State then said net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid.....	96,795.2012
Net taxable income.....	\$1,389,565.29
Tax at 3 per cent.....	\$41,686.96
Main track mileage (system).....	4,894.34
Main track mileage (State).....	1,042.70

24 Railroads and Public-service Corporations; Basis of Ascertaining Net Income.—The basis of ascertaining the net income of every corporation engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, shall be the "net operating income" of such corporations as shown by their records kept in accordance with that standard classification of accounts, when their business is wholly within this State, and when their business is in part within and in part without the State their net income within this State shall be ascertained by taking their gross "operating revenues" within this State, including in their gross "operating revenues" within this State the equal mileage proportion within this State of their in-estate business and deducting from their gross "operating

*As per standard Classification of Accounts of Interstate Commerce Commission.

revenues" the proportionate average of "operating expenses," or "operating ratio," for their whole business, as shown by the Interstate Commerce Commission standard classification of accounts. From the net operating income thus ascertained shall be deducted "uncollectible revenue," and taxes paid in this State for the income year other than income taxes and war profits and excess profits taxes, and the balance shall be deemed to be their net income taxable under this act.

Car Hire Considered.—In determining the taxable income of a corporation engaged in the business of operating a railroad under the preceding section, in the case of a railroad located entirely within this State, the net operating income shall be increased or decreased to the extent of any credit or debit balance received or paid, as the case may be, on account of car hire; and when any railroad is located partly within and partly without this State, then said net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid, as the case may be, on account of car hire.

EXHIBIT "B" TO BILL.

EXHIBIT "B."

Atlantic Coast Line Railroad Company.

Office of Comptroller.

Statement of Income Applicable to State of North Carolina for Year Ended December 31st, 1921. According to the Classification of Accounts Prescribed by the Interstate Commerce Commission.

I. Operating Income:

501. Railway Operating Revenues.....	\$16,561,435.11
531. Railway Operating Expenses.....	14,596,266.11
Net Revenues from Railway Operations	\$1,965,169.00
532. Railway Taxes Paid	458,290.46
533. Uncollectible Railway Revenues.....	20,518.08
Railway Operating Income.....	1,486,360.46

II. Non-operating Income:

Equipment Rents (Accts. 503 to 507 and 536 to 540 Net.....	†98,248.14
508. Joint Facility Rent Income.....	78,279.68
509. Income from Lease of Road.....	56.60
510. Miscellaneous Rent Income.....	26,090.32
511. Miscellaneous Nonoperating Physical Property	25,709.18
513. Dividend Income	436.64
514. Income from Funded Securities.....	40,893.47
515. Income from Unfunded Securities and Accounts	31,135.18
519. Miscellaneous Income	197.84
Total Operating Income.....	106,550.44
Gross Income	1,592,910.68

III. Deductions from Gross Income:

541. Joint Facility Rents.....	9,442.30
542. Rent for Leased Roads.....	3,000.00
543. Miscellaneous Rents	2,022.42
546. Interest on Funded Debt.....	1,214,596.30
547. Interest on Unfunded Debt.....	18,919.87
551. Miscellaneous Income Charges.....	11,724.68
Total Deductions from Gross Income	1,259,705.87
Net Income	333,205.00

Wilmington, N. C., March 10th, 1922-o.

26 UNITED STATES OF AMERICA,
Eastern District of North Carolina:

District Court at Raleigh, Fourth Circuit.

The United States of America to A. D. Watts, Comr. of Revenue Raleigh, N. C.; B. R. Lacy, State Treasurer, Raleigh, N. C.; Baxter Durham, State Treasurer, Raleigh N. C.; Jas. S. Manning Attorney General, Raleigh, N. C.; Frank Nash, Asst. Atty. General of State of North Carolina, Greeting:

We command you, and every of you, that you appear before the Judges of our District Court of the United States of America, for the Eastern District of North Carolina, at the office of the Clerk of said Court, in the City of Raleigh, in said District, on the 19th day of April next, to answer the Bill of Complaint of Atlantic Coast Line Railroad Co., citizen and resident of the State of Virginia filed in the Clerk's office of said Court, in said City of Raleigh, there and there to receive and abide by such Judgment and Decree as

†Deficit.

shall then or thereafter be made, upon pain of Judgment being pronounced against you by default.

To the marshal of the eastern district of North Carolina to execute.

Witness, The Hon. William Howard Taft, Chief Justice of the Supreme Court of the United States, at Raleigh, in said District, the 1 day of Mar., 1922, and in the 146 year of the Independence of the United States.

Issued the 31 day of March, 1922.

[Seal of the Court.]

S. A. ASHE,

Clerk U. S. District Court.

The within-named defendants are notified that unless they enter their appearance in the Clerk's office of said District Court at Raleigh and file their answer, or other defense, on or before the 20th day after service hereof, excluding the day of service, the bill filed herein will be taken as confessed and a decree entered accordingly.

S. A. ASHE,

Clerk U. S. District Court.

[Endorsed:] No. 448. Equity. In United States District Court Eastern District of North Carolina at Raleigh. Atlantic Coast Line Railroad Co. against A. D. Watts, Comr. of Revenue et al. Equity Subpoena. Returnable the 19 day in April, 1922. Duplicate original for —. —. —, Solicitors for Complainants.

Marshal's Return on Equity Subpoena.

Filed April 1, 1922.

Subpoenas received at Raleigh, N. C., March 31st, 1920. Executed at Raleigh, March 31st by leaving copy with A. D. Watts, W. F. Moody for B. R. Lacy, E. H. Baker, for Baxter Durham, Frank Nash for J. S. Manning, and Frank Nash, Asst. Atty. General.

R. W. WARD,

Marshal,

By W. W. UTLEY,

Deputy.

Fees, \$10.00.

Application for Interlocutory Injunction.

Filed April 15, 1922.

In the District Court of the United States for the Eastern District
North Carolina.

In Equity.

No. 448.

ATLANTIC COAST LINE RAILROAD COMPANY
against

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.

Comes the above named plaintiff and shows the court:

That it has instituted in this court by Bill of Complaint an action against A. D. Watts, as Commissioner of Revenue of the State of North Carolina, and other defendants as shown in said bill which is now referred to and made a part of this application, the object and purpose of the action being to secure from this Honorable Court an order enjoining preliminarily and perpetually the defendants, who are tax assessing, collecting and enforcing officers, of the State of North Carolina, from collecting or instituting proceedings to collect an income tax on the net operating revenue of complainant under statutes which complainant alleges to be violative of the Constitution of North Carolina and of the Constitution of the United States. The bill alleges and sets forth the grounds of unconstitutionality of the said income tax and of the statutes of North Carolina under which said tax is assessed and under which it will be collected by the defendants named in said bill, unless restrained by this Honorable Court, all of which is more fully alleged, set out and explained in the bill of complaint filed herein. Complainant alleges that said income tax is invalid and the statutes under which it is levied are in contravention of the Constitution of North Carolina, and the Constitution of the United States, and unless the defendants are restrained and enjoined from doing so, they will proceed on and after March 15th, 1922, to levy and collect said tax.

29

Wherefore, application is made under Section 266 of the Judicial Code for an interlocutory injunction as prayed for in said bill, and this court is petitioned to call to his assistance to hear and determine this application two other judges, and that the statutory notice of the hearing of this application be given the Governor and the Attorney General of the State of North Carolina, and each of the defendants to the said bill, and an order issued requiring the defendants to show cause at the time and place to be fixed by the court according to law why said interlocutory injunction should not issue as prayed for.

This application is based upon the verified Bill of Complaint on file herein.

THOS. W. DAVIS,
Solicitor for Complainant.

GEO. B. ELLIOTT,
SKINNER & WHIEDBEE,
Of Counsel.

Filed March 30th, 1922, at Wilson.
H. G. CONNOR, *Judge.*

Order of Application for Interlocutory Injunction.

Filed April 15, 1922.

in the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 448.

ATLANTIC COAST LINE RAILROAD COMPANY

against

A. D. WATTS, Commissioner of Revenue of North Carolina, et als.

This application for an interlocutory injunction was presented to me this 30th day of March, 1922, and having read and considered the verified bill filed in this cause, and the application for interlocutory injunction under Section 266 of the Judicial Code, and being advised that for the reasons set forth in said application and upon the grounds stated therein and in the verified bill, complainant is entitled to have its application heard under Section 266 of the Judicial Code:

It is ordered that the application be filed and a hearing of the application for an interlocutory injunction be had and proceeded with in accordance with Section 266 of the Judicial Code as amended by Act of Congress approved March 14th, 1913, and such hearing is set down for — day of March, 1922, at the United States Court Rooms in the city of Raleigh, North Carolina, at — o'clock, — M.

It is further ordered that notice of said hearing, not less than five days, shall be given to the Governor and Attorney General of the State of North Carolina, and to each of the defendants. And I hereby call to my assistance at the hearing of said application the Honorable Edmund Waddill, Circuit Judge of this Circuit, and the Honorable James E. Boyd, District Judge of the Western District of North Carolina.

This 30 day of March, 1922, at Raleigh, North Carolina.

H. G. CONNOR,
U. S. District Judge.

31 *Notice of Hearing of Application for Interlocutory Injunction*

Filed Apr. 15, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 448.

ATLANTIC COAST LINE RAILROAD COMPANY

against

A. D. WATTS, COMMISSIONER OF REVENUE OF NORTH CAROLINA
et als.

To Honorable Cameron Morrison, Governor of the State of North Carolina; Honorable James S. Manning, Attorney General of North Carolina; Honorable Frank Nash, Assistant Attorney General of North Carolina; Honorable A. D. Watts, Revenue Commissioner of the State of North Carolina; Honorable Baxter Durham, Auditor of the State of North Carolina, and Honorable Benjamin R. Lacy, Treasurer of the State of North Carolina:

You, and each of you, are hereby notified that the Atlantic Coast Line Railroad Company, complainant, has filed its verified Bill of Complaint in the District Court of the United States for the Eastern District of North Carolina against A. D. Watts, Revenue Commissioner, et als., praying an injunction against the named tax assessing, collecting and enforcing officers of the State of North Carolina from instituting proceedings to collect an income tax upon complainant's net operating revenue under the Income Tax Act of 1921 of North Carolina, and also praying that the laws of North Carolina levying said tax be declared unconstitutional, as will appear from the bill filed herein.

In this case plaintiff has made application for an interlocutory injunction under Section 266 of the Judicial Code of the United States.

The application for such interlocutory injunction will be heard in the United States District Court, in the City of Raleigh, North Carolina, on the — day of March, 1922, at — o'clock — M., and you, and each of you, are notified to appear at said time and place and show cause, if any, why the interlocutory injunction prayed for should not be granted.

Done in open court this 30 day of March, 1922.

H. G. CONNOR,

U. S. District Judge.

Service accepted

JAMES S. MANNING,

Attorney General of N. C.

Extract from the Minutes of the Court, April 15, 1922.

In the District Court of the United States for the Eastern District
of North Carolina.

In Equity.

No. 448.

ATLANTIC COAST LINE RAILROAD COMPANY

vs.

A. D. WATTS et al.

Present: The Honorable Henry G. Conner, Judge of the District
Court for the Eastern District of North Carolina.

Order.

"It is ordered that this cause be set down for final hearing on its
merits on Monday, June 13, 1922, Counsel for Plaintiff and De-
fendants being in open Court and assenting thereto; application for
Interlocutory Injunction being waived by Counsel for Plaintiff."

Answer.

Filed April 19, 1922.

In the District Court of the United States for the Eastern District of
North Carolina.

In Equity.

No. 448.

ATLANTIC COAST LINE RAILROAD COMPANY, Complainant,

v.

A. D. WATTS, Commissioner of Revenue of North Carolina; Ben-
jamin R. Lacy, State Treasurer of North Carolina; Baxter Dur-
ham, State Auditor of North Carolina; James S. Manning,
Attorney-General of North Carolina, and Frank Nash, Assistant
Attorney-General of North Carolina, Defendants.

Answer.

To the Honorable H. G. Connor, Judge of the District Court of the
United States for the Eastern District of North Carolina:

The defendants above named, answering the bill herein, respect-
fully show the Court that:

1. In answer to Article I of the complaint, the defendants aver that, though the complainant is a corporation, organized under the laws of Virginia, it is also a domestic corporation of the State of North Carolina, organized as such under Chapter 294, Private Laws of 1893; Chapter 105, Private Laws of 1899, and Chapter 77, Public Laws of 1899. The complainant accepted the benefits conferred upon

34 it by the private acts above referred to, and also those contained in the above quoted act of 1899, the railroads in North Carolina permitted by the General Assembly to consolidate with it having become under these acts a part of its system, and thus absorbed by it; and said complainant cannot now be heard to say that it is not bound by the restrictive provisions while it holds to the benefits conferred by those acts. Since the enactment of the statutes above mentioned, and the acceptance by the complainant of the benefits thereunder, it has been uniformly held by the Supreme Court of North Carolina to be a corporation of this State.

As to the allegation in Article I in regard to the mileage and proportionate mileage, in the State of North Carolina, of the complainant, the defendants have not sufficient information to form a belief, it not having filed with the Commissioner of Revenue its return for income tax.

2. Article II is admitted, except as to the individual residence of the Assistant Attorney-General, which is in Raleigh, North Carolina.

3. It is admitted that the amount in controversy herein, exclusive of interest and cost, exceeds the sum of \$3,000. But defendants expressly deny that complainant has any equity to enjoin defendants from collecting the income tax attacked by said complainant; that said railroad company will be deprived of any privilege guaranteed and secured to it by the Constitution of the United States and the Fourteenth Amendment thereof; that it will be deprived of its property without due process of law; that it will be denied the equal protection of the law in contravention of the Constitution of the United States and the Fourteenth Amendment thereof, and that the taxes sought to be imposed by virtue and under the authority of the North Carolina statute constitute a direct burden upon interstate commerce, in violation of the commerce clause of the Federal Constitution.

4. Article IV of the bill is admitted.

5. Article V of the bill is admitted.

6. Article VI of the bill is admitted.

7. Article VII of the bill is admitted.

35 8. Article VIII of the bill is admitted.

9. Article IX of the bill is admitted.

10. Article X of the bill is admitted.

11. Article XI of the bill is admitted.

12. Article XII of the bill is denied. Further answering said article, defendants respectfully show the Court:

(a) The income-tax provision of the Constitution of the State of North Carolina, quoted in Article IV of the bill, authorizes the Legislature to determine what shall be the net income to be taxed thereunder, and expressly prohibits the allowing of any deduction for living expenses. The statute, enacted by the General Assembly of 1921, in pursuance of such constitutional authority, Chapters 34 and 35 of the Public Laws of 1921, classifies income-tax payers as follows, providing for each class a different method for ascertaining taxable incomes: first, resident individuals; second, nonresident individuals, Section 200; third, resident corporations; fourth, nonresident corporations, Section 201; fifth, railroads and other public-service corporations having their lines wholly within the State; and sixth, railroads and other public-service corporations having their lines partly within the State and partly without; and the defendants are advised, and so aver, that such classification does not in any way offend against any provision of the State or Federal Constitution. No one of these classes is allowed the same deduction or exemption as those allowed to the other classes, and in each case the distinctions made are made on account of an inherent difference between the classes themselves.

(b) The statute itself (Section 202) provides the method by which the net income of railroads is to be ascertained. It declares that, as to such railroads operating wholly in the State, the net income shall be "the net operating income" as shown by their records, kept in accordance with the standard classification of accounts of the Interstate Commerce Commission. As to railroads, when their business is part within and part without the State, it declares their net income within the State shall be ascertained by taking their gross "operating revenues" within this State, including in their gross "operating revenues" within this State the equal mileage proportion within this State of their interstate business, and deducting from their gross "operating revenues" the proportionate average of "operating expenses," or "operating ratio," for their whole business, as shown by the Interstate Commerce Commission standard classification of accounts. From the sum so found, they are allowed to deduct "uncollectible revenue" and taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes, etc., and the balance shall be deemed to be their net income taxable under this act. The method thus provided by the General Assembly for ascertaining the net income of such railroads, as defendants are advised and aver, is both legally and constitutionally a proper one to apply to them, and does not offend against the interstate commerce clause of the Federal Constitution.

(c) That deductions and exemptions are allowed individuals which are not allowed ordinary corporations or railroads, and that deductions are allowed ordinary corporations which are not allowed

railroads, in specific terms, arises from the necessity to classify income-tax payers so as to arrive at their net income, and that necessity arises from differences inherent in the various businesses thus classified. Without such classification, defendants are advised and believe, it would be impossible to levy a fair and just income tax. Defendants are advised and believe that, in applying the method provided in the act, many deductions are necessarily allowed, besides those specifically set out in Section 202, "uncollectible revenue," and taxes paid in this State for the income year, etc., i. e., wages of employees, salaries of officers, if reasonable in amount, for services actually rendered in producing such income, and others too numerous to incorporate in this answer. A list of them is hereto attached, marked "Exhibit A," and is asked to be taken as part of this answer. It is admitted that complainant has copied correctly Section 306 of the Revenue Act in subsection (c) of Article XII of its bill, 37 but it is expressly denied that there has been any discrimination against railroads and in favor of ordinary business corporations.

13. Article XIII of the bill is not true as stated, and so is denied. If there are any such corporations, and the defendants, on information and belief, deny that there are such, they would pay income tax under other provisions of the statute.

14. Article XIV of the bill is not true as stated, and so is denied. It is admitted that interest paid during the tax year on outstanding bonded and other indebtedness is not one of the deductions allowed to railroads, whereas it is allowed to individuals and business corporations, but many other deductions are allowed to railroads which are not allowed to either individuals and business corporations. See Exhibit A. Defendants are informed and believe, and so aver, that the method of financing railroads is so wholly different from that of other corporations that they are necessarily in a class to themselves with other public-service corporations, and that a refusal, under such circumstances, to permit a deduction for interest on their bonded indebtedness is justified and is not a discrimination against them. The statute (Section 306, subsection 3) expressly prohibits the deduction of dividends on preferred stock to business corporations.

15. Article XV of the bill is not true as stated, and so is denied. It is expressly averred that the Income Tax Act of 1921 does operate equally and uniformly upon all taxpayers in similar circumstances, and that the variations in its operation are caused by the differences in the character of the objects upon which it operates, and it does in effect classify these various objects to meet these differences, and so the complainant is not denied the equal protection of the law and is not deprived of its property without due process of law in contravention of the Fourteenth Amendment to the Constitution of the United States. The process of arriving at the net income earned by railroads having part of their line in the State and part out is

38 necessarily long and intricate. The General Assembly, knowing this, and knowing also that the simplest way of arriving at such a net income was by using as a basis the records required to be kept by the Interstate Commerce Commission, adopted that plan, and declared in Section 202 what should be the net income of such corporations in its application to them. Defendants deny that this classification is either unreasonable or arbitrary, and aver that instead it is based upon an evident distinction in the classes, and is valid and constitutional.

16. Article XVI of the bill is not true as stated, and so is denied. The Constitution of North Carolina, no less than the Federal Constitution, permits classification in a proper case, and defendants aver that the classification in the income-tax law is both just and necessary to comply with the Constitution of the State that such taxes should be uniform.

17. Article XVII of the bill is not true as stated, and so is denied.

18. Article XVIII of the bill is not true as stated, and so is denied. The defendants affirm that the Income Tax Act of 1921 does apply to railroads and public-service corporations deriving their income from sources other than the operation of their property.

19. Article XIX of the bill is not true as stated, and so is denied. Section 3, Article V of the State Constitution, expressly authorizes the General Assembly, at its discretion, to tax incomes. If it does determine to tax incomes, it may not in any case exceed 6 per cent; it may not in any case decrease the minimum amount of exemption allowed to individuals. It may allow other deductions, not including living expenses, so that net incomes are taxed. With these limitations, then, the Legislature has authority to determine what is net income.

20. Article XX of the bill is not true as stated, and so is denied. The General Assembly has declared what shall constitute net incomes in the case of railroads, and, as appears by Exhibit A, a very large number of deductions are allowed from gross income in determining what is net income. In no sense, then, defendants aver, can a tax on such income be a tax upon a gross income or a burden on interstate commerce.

21. Article XXI of the bill is not true as stated, and so is denied. Section 202, far from prescribing a system of accounting for an interstate railroad, adopts the system partially already prescribed by Interstate Commerce Commission as a means of arriving at the net income of the complainant earned within the State of North Carolina.

22. Article XXII of the bill is not true as stated, and so is denied. It is true that the General Assembly of North Carolina, under authority conferred upon it by the amendments to the State Constitution, adopted at the general election of 1920, and which became effective January 7, 1921, declined to levy any State ad valorem tax,

but left such tax wholly to the counties and other subordinate governmental agencies of the State. It is true that it levied a franchise tax one-tenth of one per cent upon the value of railroad property in the State for the benefit of the State. It is true also that it levied an income tax of three per cent upon the net incomes of railroads and all other corporations, but defendants deny that any one or all of these methods of taxation for State purposes constitutes such taxes a burden upon interstate commerce, or violates in any sense the Constitution of the United States.

23. Article XXIII of the bill is not true as stated, and so is denied. The amendments to the State Constitution, commonly called the Taxation Amendments, were adopted at the general election of 1920, and became effective January 7, 1921. The defendants are advised and believe that such amendments authorized the General Assembly of the State to adopt the general scheme of taxation which it commenced to put into effect at the Extra Session of August, 1920, and put in full force in the Revenue Act of 1921; that a general scheme of taxation is wholly within the authority of the State, and can only be attacked when the legislation enacted in pursuance thereof, or the

administration of such taxing laws, destroys some constitutional right of the complainant; that the refusal of the State to levy an ad valorem tax upon the property of the defendant, while it permits subordinate governmental agencies to levy this tax under the rules, regulations and restrictions contained in the State Constitution, can in no sense, as defendants aver and believe, impair any constitutional right of the complainant; that the State, as defendants are advised and believe, may constitutionally levy a license or franchise tax upon complainant for the privilege of performing its functions in the State; an income tax upon income earned in the State, and also an ad valorem tax upon its property for the benefit of the State; that its refusal to levy the latter tax cannot, as defendants aver, affect the constitutionality of the levy of the franchise and income tax. Defendants particularly deny that there has been any exemption of any class of property from the general burdens of taxation, as alleged in Article XXIII of the bill, and defendants aver that the scheme of taxation of the shares in incorporated companies in the hands of the shareholders, as provided in the Revenue and Machinery Acts of 1921, has been in effect in the State for more than twenty years; said shares being taxed at the principal office of the corporation itself.

24. Article XXIV of the bill is not true as stated, and so is denied. Particularly it is denied that the Revenue Act of 1921 is in any particular retroactive or retrospective within the meaning of Section 32 of Article I of the State Constitution.

25. Article XXV of the bill is not true as stated, and so is denied. It is true that the Commissioner of Revenue has sent to complainant the form for return of income tax for the calendar year ending December 31, 1921, attached to the bill. It is admitted that he will proceed to collect, in accordance with the machinery of the law, a

proper income tax from complainant, but it is expressly denied that any greater income tax will be collected from complainant than that collected from all other public-service corporations under the same circumstances and conditions. Section 504 of the act requires
 41 the Commissioner of Revenue, when the tax is not paid within sixty days after it becomes due, to issue an order to the sheriff to collect the same. The complainant, then, is given an adequate remedy at law to recover all taxes illegally paid, in section 7979 of the C. S. of 1919, and in an act of the Extra Session of 1921, entitled "An act to refund taxes illegally collected and paid into the State treasury."

26. Article XXVI of the bill is not true as stated, and so is denied. Defendants expressly deny that the penalties set forth in Section 600 of the Income Tax Act are excessive, unreasonable, oppressive, and inequitable. Those penalties are imposed for wilful or fraudulent failure to comply with the provisions of the act, and so would not be a denial of due process of law to the complainant. The Revenue Commissioner and the Attorney-General are given authority to waive or reduce the penalties therein provided for.

Wherefore, having fully answered all the allegations of the bill herein, the defendants pray judgment:

1. That the bill be dismissed.
2. For cost of this action.
3. For such other and further relief as to the Court may seem just.

JAMES S. MANNING,
Attorney-General of North Carolina;
 FRANK NASH,

Assistant Attorney-General of North Carolina,
Solicitors for Defendants.

GEO. H. BROWN,
 WM. P. BYNUM,
 LOCKE CRAIG,
 THOS. D. WARREN,
 S. S. ALDERMAN,
Of Counsel.

42 A. D. Watts, one of the defendants, being duly sworn, says that he is State Commissioner of Revenue; that he has read the foregoing answer and knows the contents thereof; that the same is true, of his own knowledge, except as to matters therein stated on information and belief, and as to those matters he believes it to be true.

A. D. WATTS.

Sworn and subscribed to before me, this April 19, 1922.

EDWARD SEAWELL,
Deputy Clerk Supreme Court.

EXHIBIT A TO ANSWER.

1. Maintenance of Way and Structures:

Superintendence; roadway maintenance—yard; roadway maintenance—other; bridges, trestles and culverts—yard; bridges, trestles and culverts—other; ties—yard; ties—other; rail—yard; rail—other; other track material—yard; other track material—other; ballast—yard; ballast—other; track laying and surfacing—yard; track laying and surfacing—other; right of way fences—yard; right of way fences—other; crossings and signs—yard; crossings and signs—other; station and office buildings; roadway buildings; water stations; fuel stations; shops and engine houses; storage warehouses; wharves and docks; telegraph and telephone lines; signals and interlocks; miscellaneous structures; paving; roadway machines; small tools and supplies; removing snow, ice and sand; injuries to persons; insurance; stationery and printing; other expenses; maintaining joint tracks, yards, and other facilities—Dr.; maintaining joint tracks, yards, and other facilities—Cr.

2. Maintenance of Equipment:

Superintendence; shop machinery; steam locomotives—repairs; steam locomotives—depreciation; steam locomotives—retirements; freight-train cars—repairs; freight-train cars—depreciation; freight-train cars—retirements; passenger-train cars—repairs; passenger-train cars—depreciation; passenger-train cars—retirements; floating equipment—repairs; floating equipment—depreciation; work equipment—repairs; work equipment—depreciation; work equipment—retirements; injuries to persons; insurance; stationery and printing; other expenses; maintaining joint equipment at terminals—Dr.; maintaining joint equipment at terminals—Cr.

3. Traffic:

Superintendents; outside agencies; advertising; traffic associations; fast-freight lines; industrial and immigration bureaus; insurance; stationery and printing; other expenses.

4. Transportation Rail Line:

Superintendence; dispatching trains; station employees; weighing, inspection, and demurrage bureau; station supplies and expenses; yardmaster and yard clerks; yard conductors and brakemen; yard switch and signal tenders; yard enginemen; fuel for yard locomotives; water for yard locomotives; lubricants for yard locomotives; other supplies for yard locomotives; engine-house expenses—yard; yard supplies and expenses; train enginemen; fuel for train locomotives; water for train locomotives; lubricants for train locomotives; other supplies for train locomotives; engine-house expenses—train; trainmen; train supplies and expenses; signal and interlock operation; crossing protection; drawbridge operation; telegraph and tele-

phone operations; operating floating equipment; stationery and printing; other expenses; insurance; clearing wrecks; damage to property; damage to livestock on right of way; loss and damage—freight; loss and damage—baggage; injuries to persons; operating joint yards and terminals—Dr.; operating joint yards and terminals—Cr.; operating joint tracks and facilities—Dr.; operating joint tracks and facilities—Cr.

5. Transportation Water Line.

6. Miscellaneous Operations:

Dining and buffet service; salaries and expenses of general officers; salaries and expenses of clerks and attendants; general office supplies and expenses; law expenses; insurance; relief department expenses; pensions; stationery and printing; valuation expenses; other expenses; general joint facilities—Dr.; general joint facilities—Cr.

45 *Affidavit of M. S. Hawkins.*

Filed May 15, 1922.

United States District Court, Eastern District of North Carolina.

ATLANTIC COAST LINE RAILROAD COMPANY

VS.

A. D. WATTS, Commissioner of Revenue, et als.

M. S. Hawkins, being first duly sworn, deposes and says that he is Secretary of Norfolk Southern Railroad Company; that Norfolk Southern Railroad Company is a corporation originally created, organized and existing under the laws of the State of Virginia, owns and operates a line of railroad located partly in Virginia and partly in North Carolina and, in addition, during the year 1921, had, and now has, under lease a line of railroad owned by the Atlantic & North Carolina Railroad Company, extending from Goldsboro to Morehead City, and also a lease of the Durham & South Carolina Railroad, extending from Duncan to Durham, and under lease the Carthage & Pinchurst Railroad, extending from Pinchurst to Carthage;

That the line of railroad owned by the Atlantic & North Carolina Railroad Company was held under lease made by the Atlantic & North Carolina Railroad Company to the Howland Improvement Company, bearing date the 1st day of September, 1904, for a term of ninety-one years and four months from the said date, and to be fully ended and completed, commencing the 1st day of September, 1904;

That Norfolk Southern Railroad Company is the successor by assignments and mesne conveyances of said leasehold; that during the year 1921, Norfolk Southern Railroad Company duly paid the rent on said property;

That the Durham & South Carolina Railroad is held under lease bearing date of 27th day of May, 1920, and is for a term of ninety-nine years; that the rent on said property was duly paid for the year 1921;

46 That the Carthage & Pinchurst Railroad was held under lease made during the period of Federal Control of Railroads and terminated by its terms at the end of Federal Control; that Norfolk Southern Railroad Company continued to operate the same during the year 1921, until it could and did obtain authority from the Interstate Commerce Commission, under the terms of the Transportation Act of 1920, for the cessation of operation of said line of railroad, which authority was duly obtained and it ceased to operate same in January, 1922.

M. S. HAWKINS,

Sworn and subscribed to before me this 13 day of March, 1922.
[SEAL.] J. R. PRITCHARD,

Notary Public.

My commission expires Jan. 10, 1925.

47 *Affidavit of E. H. Kemper.*

Filed May 15, 1922.

United States District Court, Eastern District of North Carolina.

ATLANTIC COAST LINE RAILROAD COMPANY

VS.

A. D. WATTS, Commissioner of Revenue, et als.

E. H. Kemper, being first duly sworn, deposes and says that he is Comptroller of Southern Railway Company; that Southern Railway Company is a corporation originally created, organized and existing under the laws of the State of Virginia, owns and operates a line of railroad located partly in Virginia and partly in North Carolina, and partly in other states, and, in addition, during the year 1921, had, and now has, under lease certain lines of railroad wholly in the State of North Carolina and certain lines of railroad partly in the State of North Carolina, as follows:

(a) Owned by—North Carolina Railroad, extending from Goldsboro to Charlotte, N. C.; Raleigh, N. C. Entrance Union Station and Caraleigh Junction, N. C., to Caraleigh, N. C. held under lease bearing date of August 16, 1895, for a term of ninety-nine years from January 1, 1896.

(b) Owned by—Atlanta & Charlotte Air Line Railway Company, extending from Charlotte, N. C., to Armour, Ga., held under lease dated March 26, 1881, the agreement to remain in force as long as lessee fulfills its obligations thereunder.

(c) Owned by—Atlantic & Danville Railway Company, extending from Danville, Va., to West Norfolk, Va.; Shoulders Hill, Va., to Portsmouth, Va.; Shops, Va., to Portsmouth, Va.; James River Jet., Va., to Claremont Wharf, Va.; Hitchcock Branch Jet., Va., to Buffalo Junction, Va., to Buffalo Lithia Springs, Va.; held under lease bearing date of August 31, 1899 for a term beginning September 1, 1899, and ending July 1, 1949.

(d) Owned by—North and South Carolina Railroad Company, extending from N. & S. C. Junction to Mines, N. C.; held under lease bearing date August 31, 1899.

(e) Owned by—Southern Railway—Carolina Division, extending from Kingville, S. C., to Marion, N. C.; Sumter Jet., S. C., to Sumter, S. C.; Blacksburg, S. C., to Gaffney, S. C.; Branchville, S. C., to Columbia, S. C.; Biltmore, N. C., to Hayne, S. C.; Hendersonville, N. C., to Lake Toxaway, N. C.; Spartanburg, S. C., to Alston, S. C.; Charleston, S. C., to Savannah River, near Augusta, Ga.; Burton Branch, S. C.; Cayce, S. C., to Hardeeville, S. C.; Perry, S. C., to Seivern, S. C. Held under lease bearing date June 30, 1902, for a term of 999 years, beginning July 1, 1902.

(f) Owned by—North Carolina Midland Railroad extending from Mooresville Junction, N. C., to Winston-Salem, N. C., bearing date of February 5, 1916, and extended for a term to run and continue after December 31, 1920, until the expiration of 30 days in writing by either party to the other of the election to terminate such lease.

(S.)

E. H. KEMPER.

Sworn and subscribed to before me this 15th day of March, 1922.

[SEAL.]

(S.)

J. C. NAUGHTEN,

Notary Public.

Affidavit of J. H. Bridgers.

Filed May 15, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 448.

ATLANTIC COAST LINE RAILROAD COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, and Others, Defendants.

J. H. Bridgers, being duly sworn, says: That he is President of Henderson Water Company, a corporation incorporated under the

laws of the State of North Carolina, and engaged in the business of supplying water to the public in the town of Henderson, N. C.; that the said corporation is engaged in public service. That the said corporation is not required to and does not keep its records according to the standard classification of accounting of the Interstate Commerce Commission. That after making the deductions allowed it under the Income Tax Act of North Carolina of 1921, the said company has no taxable income. That there is attached to this affidavit and made a part hereof a duplicate of the income tax return filed by the Henderson Water Company with the Commissioner of Revenue of North Carolina, as required by the Income Tax Act of North Carolina of 1921, upon which said return it appears that the said company after making the deductions allowed corporations under the provisions of the said Income Tax Act, the Henderson Water Company has no taxable income. That there is also attached hereto and made a part of this affidavit a form for income tax return by corporations designated in Section 202 of the Income Tax Act, which has been filled out from the books of the Henderson Water Company and which correctly shows the amount of taxable income upon which the said company would be required to pay the income tax if it came within the corporations designated by said Section 202 and was required to keep its accounts according to the standard classification of accounting of the Interstate Commerce Commission, and from which it appears that said corporation would be required to pay an income tax of \$167.21, if its income taxable under the law were required to be determined on the basis of said return.

(S.)

J. H. BRIDGERS.

Sworn and subscribed to before me this 14th day of March, 1922.

(S.)

J. A. SCOTT,

Notary Public.

My commission expires 2nd day of May, 1922.

50

EXHIBIT "A."

Copy.

State Department of Revenue.

Public-service Corporation Income Tax Return Other Than Railroads.

For Calendar Year Ending December 31, 1921.

Name and kind of business, Henderson Water Company.
Business address, Henderson.

We, the undersigned, president and treasurer of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return, including the accompanying schedules and statements, has been examined by him and is, to the best of his knowledge and belief, a true and complete return

made in good faith, for the taxable period as stated, pursuant to the Revenue Act for 1921 and the Regulations issued under authority thereof.

_____,
President.

_____,
Treasurer.

Sworn to and subscribed before me, this — day of —, 1922.

_____,
(Official capacity.)

Operating Revenues, in this State, including mileage proportion of interstate business as per standard Classification of Accounts of Interstate Commerce Commission	\$32,101.83
Operating Expenses, as per standard Classification of Accounts of Interstate Commerce Commission	26,079.00
Net operating revenue	\$6,022.00
All other income .....	.....
Total income	\$6,022.00
Less taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes	771.00
Net taxable income	\$52.41
Tax @ 3%	\$167.23

31 Railroad and Public-service Corporations; Basis of Ascertaining Net Income.—The basis of ascertaining the net income of every corporation engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, shall be the "net operating income" of such corporations as shown by their records kept in accordance with that standard classification of accounts, when their business is wholly within this State, and when their business is in part within and in part without the State their net income within this State shall be ascertained by taking their gross "operating revenues" within this State, including in their gross "operating revenues" within this State the equal mileage proportion within this State of their interstate business and deducting from their gross "operating revenues" the proportionate average of "operating expenses," or "operating ratio," for their whole business, as shown by the Interstate Commerce Commission standard classification of

accounts. From the net operating income thus ascertained shall be deducted "uncollectible revenue," and taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes, and the balance shall be deemed to be their net income taxable under this act.

Car Hire Considered.—In determining the taxable income of a corporation engaged in the business of operating a railroad under the preceding section, in the case of a railroad located entirely within this State, the net operating income shall be increased or decreased to the extent of any credit or debit balance received or paid, as the case may be, on account of car hire; and when any railroad is located partly within and partly without this State, then said net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid, as the case may be, on account of car hire.

Copy.

Form 3.

State Department of Revenue.

Corporation Income Tax Return.

For Calendar Year Ended December 31, 1921.

(Make Affidavit on This Page for Either Blank.)

Kind of business, Henderson Water Company—Public Water Supply.
Business address, Henderson, N. C.

We, the undersigned, president and treasurer of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return, including the accompanying schedules and statements, has been examined by him and is, to the best of his knowledge and belief, a true and complete return made in good faith, for the taxable period as stated, pursuant to the Revenue Act for 1921 and the Regulations issued under authority thereof.

(S.)

(S.)

J. H. BRIDGERS,
President.
J. H. BRIDGERS,
Treasurer.

Sworn to and subscribed before me, this 10 day of Mar., 1922.

_____,
(Official capacity.)

Corporation Income Tax Return.—Continued.

What was the net income for the calendar year 1921 returned to the U. S. Government before taking off any exemption allowed by the Federal law or State income tax		\$	None.
Bad debts charged off in Federal return and not deductible in this return		\$	None.
Total		\$	.....
Deduction.			
Dividends not taxable by State, included in Federal return			.....
Net income under State law, all of which is taxable		\$	.....
Tax at 3 per cent.		\$	None.

If Above Form Is Used, It Is Not Necessary to Fill Out This Form.

Gross Income.

1. Gross sales less returns and allowances	\$	.....
Plus inventory close of year		.....
2. Less cost of raw materials	\$	.....
.....	
.....	
.....	
Wages and labor		.....
Total raw materials, wages and labor	\$	.....

Plus inventory beginning year.....	\$.....
Gross income from operation.....	32,101.83
3. Gross income from operations other than trading or manufacturing.....	\$.....
4. Taxable interest received from all sources.....	.....
5. Rentals.....	.....
6. Royalties.....	.....
7. Income received from partnership.....	.....
8. Total dividends received from foreign corporations, no part of which corporation's income is subject to income tax under the State law. Attach statement showing names of corporations and amount received from each.....	.....
9. Total dividends received from foreign corporations, part of which corporation's income is subject to income tax under the State law. Attach statement showing names of corporations and amount received from each.....	.....
10. Gross income from all other sources subject to tax.....	.....
11. Total income, 3 to 10.....	.....
12. Total gross income, 1 to 11.....	\$.....

Corporation Income Tax Return.—Continued.

53

Deductions.

1. All the ordinary and necessary expenses paid during the income year in carrying on any trade or business	\$
2. Reasonable compensation of officers .....	.....
3. Rentals or other payments required to be made as a condition of the continued use or possession, for the purpose of the trade of property to which the taxpayer has not taken, or is not taking title, or in which he has no equity .....	.....
4. All interest paid during the income year on indebtedness, except interest on obligations contracted for the purchase of nontaxable securities. Dividends on preferred stock shall not be deducted as interest .....	.....
5. Taxes for the income year, except taxes on income and war profits and excess profits taxes, inheritance taxes, and taxes assessed for local benefit of a kind tending to increase the value of the property assessed .....	.....
6. Dividends from stock in any corporation the income from which shall have been assessed and the tax on such income paid by the corporation under the provisions of this act: Provided, that when only a part of the income of any corporation shall have been assessed under this act only a corresponding part of the dividends received therefrom shall be deducted. Attach statement of such dividends .....	.....
7. Losses sustained during the income year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit .....	.....
8. Debts ascertained to be worthless and charged off within the taxable year if the amount has previously been included in gross income in a return under this act .....	.....

[illegible]

Corporation Income Tax Return.—Continued.

55

Reconciliation of Net Income and Analysis of Changes in Surplus.

Column 1.		Column 2.	
1. Net income from line —, page —	\$	4. Unallowable Deductions	\$
Nontaxable Income:		(a) Income and profits taxes paid to the U. S., its possessions or foreign countries . . . . .	.....
(a) Interest on obligations of the United States and its possessions wholly exempt . . . . .	.....	(b) Life insurance premiums on lives of officers . . . . .	.....
(b) Interest on obligations of State of N. C. . . . .	.....	(c) Income taxes paid to State of North Carolina . . . . .	.....
(c) Dividends on stock of N. C. corporations subject to N. C. income tax . . . . .	.....	(d) Special improvement taxes tending to increase the value of the property assessed . . . . .	.....
(d) Difference between book profit on sale of capital assets and as shown herein . . . . .	.....	(e) Furniture and fixtures, additions, or betterments treated as expense on the books . . . . .	.....
(e) Charges against reserves for bad debts, contingencies, etc. (to be detailed) . . . . .	.....	(f) Renewals and replacements . . . . .	.....
(a) . . . . .	.....	(g) Interest paid to purchase nontaxable securities . . . . .	.....
(b) . . . . .	.....	(h) Additions to reserves: . . . . .	.....
	
	

(c) .....	.....	Other Unallowable Deductions:	.....
3. Surplus and undivided profits as shown	.....	.....	.....
by balance sheet at close of preced-	.....	.....	.....
ing taxable year.....	.....	.....	.....
Other Credits to Surplus:	.....	5. Dividends paid during taxable year..	.....
.....	.....	(a) Date paid .....	.....
.....	.....	Character .....	.....
.....	.....	Date paid .....	.....
.....	.....	Character .....	.....
.....	.....	Date paid .....	.....
.....	.....	Character .....	.....
.....	.....	Date paid .....	.....
.....	.....	Character .....	.....
.....	.....	Other Debits to Surplus to be Detailed:	.....
.....	.....	(a) .....	.....
.....	.....	(b) .....	.....
.....	.....	(c) .....	.....
.....	.....	Total Column 2.....	\$.....
Total Column 1.....	\$.....		
Surplus and undivided profits shown by			
balance sheet close of year—Column			
1 minus Column 2.....	\$.....		

Affidavit of H. C. Prince.

Filed May 15, 1922.

In the District Court of the United States for the Eastern District of
North Carolina.

In Equity.

No. 448.

ATLANTIC COAST LINE RAILROAD COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.

Affidavit of H. C. Prince.

STATE OF NORTH CAROLINA,

County of New Hanover:

Personally appeared before me, a Notary Public, in and for the State of North Carolina and County of New Hanover, H. C. Prince, a resident of the aforesaid State and county, who, upon being duly sworn, deposes and says that:

1. He is Comptroller of the Atlantic Coast Line Railroad Company and has occupied that position since July 1, 1902, (except from July, 1918, to February 29, 1920), and as such Comptroller he prescribed the accounting methods of said railroad company and directed and supervised its accounts in accordance with such methods. From July, 1918, to February 29, 1920, he was Federal Auditor for the United States Railroad Administration and as such directed the accounting for the operations of the Atlantic Coast Line Railroad Company's properties, which during that period were operated by the United States Railroad Administration; that he is an expert accountant and is thoroughly familiar with accounting.

2. He has read the Bill of Complaint and the Answer filed in this cause and the sections of the Income Tax Law of 1921 of North Carolina in reference thereto.

3. Affiant attaches hereto the Classification of Income Profit Loss and General Balance Sheet Account for Steam Roads prescribed by the Interstate Commerce Commission, in accordance with section 29 of the Act of Congress to Regulate Commerce, effective on July 1, 1914, and which is now and has been in effect since July 1, 1914, which said Classification is marked Exhibit "A."

57 4. Affiant also attaches hereto Classification of Operating Revenues and Operating Expenses of Steam Roads prescribed

by the Interstate Commerce Commission in accordance with section 209 of an Act to Regulate Commerce effective July 1, 1914, and which has been in effect since that date and is now in effect, which said Classification is marked Exhibit "B."

5. Affiant further says that he is thoroughly familiar with the Classification of Accounts of the Interstate Commerce Commission, and has been so familiar for many years, and that there is no such designation in the Classification of Accounts of the Interstate Commerce Commission as "net railway operating income."

6. Affiant further says that if "net railway operating income" is to be construed as that income defined as such in section 1 of the Federal Control Act, Section 15-a of the Interstate Commerce Act and Section 209 of the Transportation Act, 1920, then the basis of ascertaining such "net railway operating income" of a railroad wholly within the State of North Carolina differs, under the Act from the method provided in the Act, for ascertaining such income for railroads whose business is partly within the State and partly without the State, for that those railroads whose business is partly within and partly without the State are not allowed deductions from their gross operating income, which items are allowed railroads wholly within the State, and which items are as follows:

Locomotive hire,
Working equipment hire,
Floating equipment hire, and
Joint facility rents,

all of which accounts are fully set forth in the Classification of Accounts attached hereto. Therefore, in making up the return for taxes for public service corporations described in Section 202 of the Income Tax Act of 1921 whose lines are wholly within the State of North Carolina, these companies necessarily are entitled under the law to these deductions and necessarily will pay a smaller rate of income than a public utility company doing business within and without the State of North Carolina, and to the extent to which these deductions are made there is an actual discrimination against the corporation whose lines are partly within and partly without the State.

7. Affiant further says that under all rules of accounting net income is, as a matter of fact, that amount received by a corporation after the deduction from its gross income of all of the expenses of operating its property which expenses necessarily include such items as rentals paid for property used in earning said income, and interest paid on indebtedness on such property used in earning said income.

H. C. PRINCE.

Subscribed and sworn to before me this 13th day of May, 1922.

[SEAL.]

BERTRAM QUELCH,

Notary Public.

My commission expires May 31st, 1922.

59 In the District Court of the United States for the Eastern District of North Carolina.

ATLANTIC COAST LINE RAILROAD COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.
Defendants.

Affidavit of Nathan O'Berry.

Filed May 23, 1922.

Nathan O'Berry, being first duly sworn, deposes and says:

1. That he is a citizen and resident of the State of North Carolina and County of Wayne, that he is President of Enterprise-Whiteville Lumber Company.

2. That said company is an industrial corporation engaged in operating lumber mills located respectively at Whiteville and Mt. Olive, North Carolina.

3. That said company, as a part of its business constructed a line of railroad extending from Whiteville, N. C., to Butlers, N. C., a distance of about 27 miles, and also constructed a line of railroad extending from Mt. Olive, N. C., to New Camp, N. C., a distance of about 18 miles.

4. That said railroads were established and maintained solely by the owner of the lands upon which the said roads were constructed and the principal business of said railroad is the transportation of logs, lumber and other articles of the owners of said railroad.

5. Acting under the provisions of section 3413 of the Consolidated Statutes of North Carolina, the said corporation applied to the Corporation Commission of North Carolina for authority to to said corporation to transport between the termini of said two lines of railroad, commodities other than that owned by the said lumber company, and for authority to charge therefor reasonable rates to be approved by said corporation.

6. The Corporation Commission, under the powers vested in it under said section 3413 of the Consolidated Statutes of North Carolina, duly authorized the said corporation to act as a common carrier between the termini of its said two lines of Railroad and established a scale of rates which said corporation might charge for the transportation of the kind and character of commodities which it was authorized to transport for others for such services.

7. That the said Corporation does not have any Tariff filed with Interstate Commerce Commission, and is not authorized to and does not engage in the transportation of freight or passengers in interstate

commerce, or between any points other than those on its own line. That the said corporation, during the year 1921, paid interest on account of money borrowed, that the said corporation in making its income tax returns to the Commission of Revenue of the State of North Carolina, deducted from its gross income the interest so paid in order to arrive at its net income, this deduction being made in addition to the other deductions allowed under section 306, schedule D of the Revenue Act of North Carolina.

8. This affiant is informed and believes that it was entirely proper under the laws of North Carolina for said corporation to deduct the interest paid during the year 1921 from its gross income in order to ascertain the net income subject to tax.

(S.)

NATHAN O'BERRY.

Sworn and subscribed to before me this 17th day of May, 1922.

[SEAL.]

C. W. BRINKLEY,
Notary Public.

My Commission expires January 24th, 1924.

Affidavit of A. R. Turnbull.

Filed May 23, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

ATLANTIC COAST LINE RAILROAD COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.

A. R. Turnbull, being first duly sworn, deposes and says:

1. That he is President of the Rowland Lumber Company.
2. Rowland Lumber Company is a corporation duly organized and existing under the laws of the State of North Carolina, the principal business of the said company is the manufacture of lumber.
3. That it operates a large mill in North Carolina, located at New Bern, and has under lease a line of railroad extending from Clarks Junction, a point on the Atlantic & North Carolina Railroad, westwardly to and beyond New River and thence to Chinquapin, and a few miles beyond, where it connects with a line of railroad owned by Rowland Lumber Company, which extends to Kenansville, where it connects with a line of railroad owned by Atlantic & Carolina Railroad Company.
4. The principal business of the said railroad running from Kenansville to Clarks Junction, through Chinquapin is the transportation of logs and lumber for the owner of such railroad.

5. The Corporation Commission of North Carolina, acting under the power vested in it by section 3413 Consolidated Statutes of North Carolina, has granted to Rowland Lumber Company authority to transport commodities of certain kinds and character other than those owned by the said Rowland Lumber Company over that part of the said line of railroad between Kenansville and Chinpuapin and to charge therefor a scale of rates fixed and established by the Corporation Commission of North Carolina.

6. Rowland Lumber Company does transport for others than itself commodities of the kind and character authorized by said authority to be transported and charges therefor the scale of rates authorized by the Corporation Commission.

62 7. That the Rowland Lumber Company is not engaged in interstate commerce and has never filed any tariffs with the Interstate Commerce Commission, and has not been authorized to engage in interstate commerce, and is prohibited under the law from so doing until it has filed tariffs with the Interstate Commerce Commission as required by the Interstate Commerce Act.

8. That during the calendar year 1921, which is the income tax year for 1921 in the state of North Carolina, Rowland Lumber Company paid rent for the line of railroad operated by it as aforesaid and also paid other rents for properties used in its said business and to which it had not taken and was not taking title, and to which it had no equity except its leasehold, and also paid sums as interest for money borrowed and used in its business.

9. Affiant is informed and believes that Rowland Lumber Company is, under the income tax law of North Carolina, schedule D of Chapter 34, entitled to deduct the amounts so paid as interest and rent, together with other deductions allowed by said schedule from its gross income, in order to arrive at its net income subject to tax under the said tax laws of North Carolina.

10. That the said railroad is of standard gauge and can and does receive cars from other lines of railroad, which it transports to destination on its own line.

(S.)

H. R. TURNBULL

Sworn and subscribed to before me this 20th day of May, 1922

[SEAL.]

J. E. DAY, JR.,
Notary Public.

Commission expires Sept. 18, 1923.

Affidavit of C. D. Bradham.

Filed May 25, 1922.

In the District Court of the United States for the Eastern District
of North Carolina.

In Equity.

No. 448.

ATLANTIC COAST LINE RAILROAD COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.*Affidavit of C. D. Bradham.*

C. D. Bradham, being first duly sworn, deposes and says that he is President of the Atlantic & North Carolina Railroad Company; that prior to the year 1921, the Atlantic & North Carolina Railroad Company leased to the Howland Improvement Company its line of railroad, extending from Morehead City to Goldsboro, North Carolina.

That the Norfolk Southern Railroad Company is the successor in title to the said leasehold interest granted by said lease and during the year 1921 was in possession of said line of railroad under said lease and used the same exclusively and conducted and carried on the business of a common carrier over said line of railroad.

That during the said year 1921, Norfolk Southern Railroad Company paid the Atlantic & North Carolina Railroad Company the amount of rent required by said lease to be paid for the continued use of said property in the trade or business of Norfolk Southern Railroad Company; that the payment of the said rent was a condition precedent to the continued use of the said property by the Norfolk Southern Railroad Company in its business.

That the Norfolk Southern Railroad Company has not taken title to the said property, was not taking title thereto, and has no equity in the property owned by the Atlantic & North Carolina Railroad Company.

That under the terms of the said lease, Norfolk Southern Railroad Company, as Lessee, is required to pay any income tax levied upon the income of the Atlantic & North Carolina Railroad Company derived from or under said lease.

That the amount of money received from Norfolk Southern Railroad Company as rent for the use of said property is substantially the entire income of the Atlantic & North Carolina Railroad Company.

C. D. BRADHAM.

Subscribed and sworn to before me this 24 day of May, 1922.

[OFFICIAL SEAL.]

S. E. LANCASTER,
C. C. Court, Craven County.

65

Affidavit of Charles J. Joseph.

Filed May 25, 1922.

In Equity.

No. 448.

In the District Court of the United States for the Eastern District of
North Carolina.

ATLANTIC COAST LINE RAILROAD COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.

Affidavit of Charles J. Joseph.

STATE OF NORTH CAROLINA,
County of New Haven:

Charles J. Joseph, being first duly sworn, deposes and says:

1. That from 1900 to 1902 he was Real Estate Agent and Tax Agent of the Plant System of Railroads, in charge of the States of Georgia, Florida and Alabama; that from 1902, when the Plant System of Railroads was sold to and merged into the Atlantic Coast Line Railroad Company, a Virginia corporation, he was Tax Agent of the Second and Third Divisions of the Atlantic Coast Line Railroad Company, in charge of the States of Georgia, Florida and Alabama, and a part of South Carolina; that from 1907 to date, he has been Tax Agent of the entire system of the Atlantic Coast Line Railroad Company, in charge of the States of Virginia, North Carolina, South Carolina, Georgia, Florida and Alabama; that from 1883 to 1900 he was civil engineer and chief clerk to Superintendent of the Florida Southern Railroad Company, Savannah, Florida and Western Railroad Company, and the Plant System of Railroads, at various periods of time; that his duties as such Real Estate Agent and Tax Agent were to return for taxation the properties of such railroads, in the several states traversed by them, and to appear before the tax boards of the said States in the matter of the assessments of properties of said railroads.

2. That he has read the Bill of Complaint in this cause and is familiar with the facts set forth therein, and with this litigation.

66 3. That the North Carolina Tax Commission in the years 1919 and 1920 and the Commissioner of Revenue of North

Carolina in the year 1921 assessed the property of the Atlantic Coast Line Railroad Company in North Carolina for ad valorem purposes, as follows:

Year.	Tangible assessment.	Intangible assessment.	Total assessment.
1919	\$15,891,000	\$18,754,345	\$34,645,345
1920	39,620,930	11,246,870	50,867,800
1921	39,916,847	11,246,870	51,163,717

4. That the said assessment was used not only for advalorem taxes but also as a basis for a tax called a franchise tax of one tenth of one per cent payable to the State, which tax was paid by the Atlantic Coast Line Railroad Company in 1920 under protest.

5. That in September, 1921, the Atlantic Coast Line Railroad Company brought suit to have declared said so-called franchise tax unconstitutional and to have the said ad valorem assessment declared invalid and reduced.

6. That by stipulation made in October, 1921, in said suit, Atlantic Coast Line Railroad Company paid ad valorem tax based upon an assessment of \$34,645,345, amounting in the aggregate to the sum of \$455,516.64 which was \$89,768.74 more than the tax it paid for the year 1920.

7. That if the said assessment which is being contested in said suit so brought and which is now pending in the Supreme Court of the United States is declared valid, the Atlantic Coast Line Railroad Company will have to pay to the State of North Carolina for ad valorem taxes for the year 1921, to the various counties, cities and subdivisions, in addition to the taxes already paid for the year 1921, the sum of approximately \$179,000.00, and if the said so-called franchise tax of one tenth of one per cent is sustained, it will have to pay an additional tax of \$51,163.00, making a total of \$230,163.00 additional taxes. In addition to which, if the said income tax, which is being contested in this suit, is declared valid and the construction placed upon said statute by the Commissioner of Revenue is sustained, and said railroad company made to pay in accordance with the form attached to the Complaint, Marked Exhibit "A," an additional tax will have to be paid by the Atlantic Coast Line Railroad Company amounting to \$41,686.96.

8. The ad valorem tax is based, not only on real and personal property, but upon the intangible value of the property of this company as found by said Commissioner of Revenue, in addition to which the said franchise tax is also based upon said intangible property in part.

C. J. JOSEPH.

Sworn and subscribed to before me this 24th day of May, 1922.

[SEAL.]

C. S. MORSE,

Notary Public.

My commission expires: February 19, 1924.

Affidavit of O. S. Thompson.

Filed June 5, 1922.

In the District Court of the United States for the Eastern District
of North Carolina.

In Equity.

SOUTHERN RAILWAY COMPANY et als., Plaintiffs,

vs.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, et als.,
Defendants.

Railroad Income Tax Suits.

Affidavit of O. S. Thompson.

O. S. Thompson being duly sworn, deposes and says:

Since 1906 affiant has been connected with the Corporation Commission of North Carolina, and with the State Department of Revenue since its creation in 1921. The Corporation Commission, in addition to its duties as such, was by statute created the State Tax Commission with the duties of administering the tax laws of the State. Affiant's position with the said State Tax Commission was that of Tax Clerk, and as such his duties were the general supervision of the details of the administration of the tax laws of the State. While Tax Clerk of the State Tax Commission affiant had extensive experience with the Standard Classification of Accounts of the Interstate Commerce Commission in connection with preparing the reports of the Corporation Commission based in part on the said Standard Classification.

Affiant is now Deputy Commissioner of Revenue of North Carolina and acting Chief Clerk of the State Department of Revenue and his duties as such are similar to those formerly performed by him as Tax Clerk of said State Tax Commission. Prior to 1906 affiant served as an employee of the Southern Railway Company as clerk handling taxation matters.

In his capacity as Deputy Commissioner of Revenue and acting Chief Clerk of the State Department of Revenue the affiant is familiar with the requirements of that Department as to returns for taxation by taxpayers, with the forms of such returns, and is custodian of the records of the State Department of Revenue. Affiant is familiar with the administration of the tax laws of the State by the State Department.

The State Department of Revenue has only one blank for returns for income tax which is sent out to and used by all railroad corporations engaged in the operation of railroads. This is known as Form 7, and is attached to this affidavit, marked Exhibit A.

This form is required by the State Department of Revenue to be filled out by all railroads doing business in the State of North Carolina, whether operating partly within or partly without the State, whether operating wholly within the State but as common carriers with interstate railroads, or whether doing wholly intrastate business. This Form 7 requires a report by all such railroad corporations of their net income as defined by the Income Tax Act of 1921, under the provisions of section 202 of that Act, and based upon and according to the Standard Classification of Accounts of the Interstate Commerce Commission.

The State Department of Revenue requires all such railroad corporations to make return for income taxation upon this form and ascertain the net income of such railroads for taxation without discrimination according to the provisions of the said section 202.

Affiant has read the affidavits of Nathan O'Berry, President of the Enterprise-Whiteville Lumber Company, and of Mr. A. B. Turnbull, President of the Rowland Lumber Company, filed in their suits by the Norfolk and Southern Railway Company. It is true that these lumber companies and other similar companies are not classed as railroads by the State Department of Revenue, are not treated as railroads for income tax purposes or for any other purposes whatsoever, and are not required to make returns for income tax according to the Standard Classification of Accounts and upon Form 7, but are required to and do make return for income tax on Form 3, which is the Form required by the Department for corporations

in general other than the railroads and other public service corporations taxed according to section 202. In fact, these lumber companies and other similar companies are not railroads and are not public-service corporations. As is stated in the said affidavit by the presidents, their principal business is the lumber business, only such transportation as they carry on is principally the transportation of their own property as incidental to the lumber business. Under section 3413, Consolidated Statutes, the Corporation Commission has the power to grant to such companies authority to transport certain commodities other than their own property, subject to the supervision of the Commission. But the affiant is informed and believes that the purpose of such provision is simply to allow such companies to accommodate immediate communities in which they operate; that when such authority is granted to and exercised by such companies they do not engage in the business of transportation as common carriers for others for profit, but only as the purely incidental service of accommodation; that in any such case the transportation of property of others by such a corporation is wholly negligible in amount and purely incidental to the principal business of the corporation, which is the lumber business.

Affiant states, therefore, as a matter of his own knowledge, that the Income Tax Act of 1921, as administered by the State Department of Revenue, applies exactly in the same way and without any discrimination whatsoever to all railroad corporations doing any business in the State engaged in railroad operation, whether foreign

or domestic, whether operating partly within and partly without the State, or wholly within the State. All are required to make return for income tax according to the Standard Classification of Accounts and under section 202, and exactly the same deductions are allowed to all, without discrimination.

Not only is the entire class of railroads subjected to income taxation under the provisions of section 202 with ascertainment of net income upon the basis of the Standard Classification of Accounts

but the same is true as to the broader class of all strictly public-service corporations and which the affiant is informed and believes are not public-service corporations at all.

The State Department of Revenue has one form for income tax return for all public service corporations other than railroads, Form 8, a copy of which is attached hereto and marked Exhibit B, and which form is substantially identical with Form 7 upon which railroads are required to make return. The Department of Revenue requires, therefore, not only of railroads, but of all other public service corporations, that they file returns for income tax upon the basis of the Standard Classification of Accounts, under the provisions of section 202.

Affiant has read the affidavit of Mr. J. H. Bridges, President of the Henderson Water Company, in which Mr. Bridges states that the Henderson Water Company is not required to and does not keep its records according to the Standard Classification of Accounting and that it did not make return for income taxation according to the said classification under the provisions of section 202. Affiant states that the returns for income taxation in the office of the Department of Revenue for the year ending December 31, 1921, have not yet been audited and checked for correctness. If what Mr. Bridges says with reference to the return made by the Company is true, his company will be required to amend its return and to file a return on Form 8 according to the said Standard Classification and under the provisions of section 202. As the Department of Revenue interprets the Income Tax Act, the Henderson Water Company, as well as all other public service corporations, are required by it to make return for income tax in accordance with the accounting system of the Standard Classification. The auditing of income tax returns for the said year is in progress at this time, but has not been completed, and, with reference to railroads and other public-service corporations, has been held over pending decision in these suits as to the validity of the income tax as to such corporations, in view of the plaintiff's attack upon the income tax law as applied to them.

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O. S. THOMPSON,

Affiant.

Subscribed and sworn before me this the 5 day of June, 1922.

[SEAL.]

W. H. PITTMAN,

Notary Public.

My commission expires July 29, 1922.

73 *Affidavit of A. J. Maxwell.*

Filed June 5, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

SOUTHERN RAILWAY Co., et al., Plaintiffs,

vs.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, et als., Defendants.

Railroad Income Tax Suits.

Affidavit of A. J. Maxwell.

A. J. Maxwell, being first duly sworn, deposes and says:

Affiant is a member of the State Corporation Commission of North Carolina and has been such since 1910, during which time the said commission was, until 1921, also the State Tax Commission with the duties and functions with reference to administering the tax laws of the State imposed upon the newly created State Department of Revenue by the statute of 1921. In such position the affiant has been directly connected in an official capacity with the administration of the tax laws of the State until the creation of the State Department of Revenue to replace the State Tax Commission as such. In such capacity the affiant was in constant consultation with the finance committees of the General Assembly at the time of the drafting of the Income Tax Act of 1921. In such capacity the affiant has had extensive experience familiarizing him with the Standard Classification of Accounts of the Interstate Commerce Commission, has made a special and comparative study of the taxation system of other states and of the subject of taxation.

When the enactment of the Income Tax Act of 1921 was under consideration in the finance committees of the General Assembly, the railroads were heard on the matter and they made the same objection to the provisions of Section 202 that they are now making in these suits. They argued that the application of those provisions to them would not lead to an ascertainment of their net income because certain items, notably interest on bonded indebtedness and rentals paid for leased properties, were not included in the operating expenses in the said Standard Classification, whereas as to individuals and to corporations other than public-service corporations deductions were allowed under general terms of the Act which the railroads alleged to be analogous to such interest and rentals.

74 The legislative committees considered these objections fully and

carefully. In enacting the Act in the terms, finally adopted, the General Assembly considered certain well known facts with reference to the method in which railroad corporations are financed. It is a general rule that railroads are financed almost entirely by bond issues, their stock being issued largely incidentally and sometimes even distributed as bonus with the bonds. The rule is that the capital finances are procured by bond issues. This being the case, interest paid on the bonds is properly considered not as a current, operating, or business expense, but as a capital expense. The legislature considered that "net income" as generally understood and as judicially defined means the business revenues less all those expenses incurred in the earning of such revenue, but not deducting any expense on account of or to provide for capital or permanent investment in the business. It was manifest, therefore, that if interest on bonds should be allowed as a deduction in arriving at net income of railroads, this would be the allowing of a capital expense not an operating or business expense, and the result obtained after making such deductions in addition to operating and business expenses would not be the net income of the railroad but less.

With reference to the matters of rentals paid for the lines leased and operated by the railroads, the committees considered the well known facts that these leases are usually for long terms and with numerous collateral obligations which make them amount practically to purchases of the lessor road's properties by the lessee, and that, this being true, the consideration paid for such long leases of property used fully as if the property of the lessee in its business is really not an operating expense but is by clear analogy and in practical effect a capital expense. If these expenses were allowed as deductions to the plaintiffs, the result would be that they would have no income subject to tax until they had earned enough to provide, not only for all business and operating expenses, but also for all capital expenses and had paid all interest on their bonds; in other words, it would amount to nothing more than a tax on the savings of railroads, which would render the tax utterly incommensurate with that imposed as income tax on individuals and other ordinary corporations.

Affiant states it as his opinion that the Income Tax Act as applied to railroads and other public service corporations under the provisions of Sec. 202 results in a strictly fair and just tax upon their net income, entirely commensurate in scope and burden with the tax imposed on other corporations, and individuals, except that perhaps, in view of the fact that individuals are allowed no deduction whatever for living and family expenses, which expenses are analogous to many items allowed all corporations as deductions, the tax bears relatively more heavily on individuals than on corporations by reason of the constitutional inhibition against allowing such deductions to individuals.

As to the contention of the plaintiffs that it is arbitrary classification and discrimination to base a classification on the question whether the taxpayer is required to keep his accounts in accordance with the Standard Classification, the affiant is advised and believes,

and so states, that so long as all railroads are placed within the class and are treated alike without discrimination, the classification is reasonable and not arbitrary, because the distinction of being railroads and not other corporations is a practical and reasonable basis of distinction and classification. Affiant asserts further that all railroads are taxed alike under the Income Tax Act of 1921. All are required to make return for taxation on Income Tax Blank Form 7, according to the Standard Classification of Accounts; and that the class is even broader than that of railroads, including all other public service corporations, these being required to make return on Form 8, according to the same Standard Classification, as sworn to in the affidavit of O. S. Thompson filed by the defendants herein.

When railroads keep the Standard Classification of Accounts, under Federal or State Requirements, the only practical method of requiring return for income tax to be made is according to such classification of accounts, and for the State to require different accounting, or to require return according to another system of accounting, would conflict practically with the system of accounting, would conflict practically with the power of the Interstate Commerce Commission to prescribe uniform classification of accounts. The State of North Carolina has not undertaken to prescribe any system of accounting for the plaintiffs or other railroads in conflict with that already required to be kept by the Interstate Commerce Commission, but has adopted that system as the best and most practical basis for the calculation of net incomes for taxation.

A. J. MAXWELL,

Affiant.

Subscribed and sworn to before me this the 5 day of June, 1922.

[SEAL.]

W. H. PITTMAN,

Notary Public.

My commission expires July 29, 1922.

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Affidavit of R. O. Self.

Filed June 5, 1922.

In the District Court of the United States for the Eastern District
of North Carolina.

In Equity.

SOUTHERN RAILWAY COMPANY et als., Plaintiffs,

vs.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, et als.,
Defendants.

Railroad Income Tax Suits.

Affidavit of R. O. Self.

R. O. Self being duly sworn, deposes and says:

Affiant is the clerk of the State Corporation Commission of North Carolina, has been such since the first of September 1919, and as such is custodian of the records of the said Commission and is thoroughly familiar with the administering by the Commission of its duties and powers given it by statute. He is thoroughly familiar with the classification made by the Corporation Commission of corporations subject to its supervision.

Affiant has read the affidavit of Mr. A. R. Turnbull, President of the Rowland Lumber Company, which affidavit is filed by the Norfolk Southern Railroad Company in these suits, and affiant is familiar with contents thereof. He has also read and is familiar with the contents of the affidavit of Mr. Nathan O'Berry, President of the Enterprise-Whiteville Lumber Company, filed by the said plaintiff in these suits.

The said Rowland Lumber Company, and the said Enterprise-Whiteville Lumber Company do what is known as a limited transportation business, and are authorized by the Commission to carry on their logging roads certain limited commodities other than their own. These corporations are not railroad Corporations, but are lumbering corporations. Their lines of tramway, or railroad, are constructed by them for the purpose of hauling logs and lumber and operating their lumber business. When such roads are established there are frequent demands by the communities through which they run, for them to transport other commodities for the convenience and accommodation of the inhabitants of those communities.

78 Under Section 3413, Consolidated Statutes, the Corporation Commission has the power to, and in proper cases does, grant authority to such logging or lumber companies to carry for hire over their logging, or tramway, roads commodities of others within certain limitations.

These corporations are not classed, considered, or treated by the Corporation Commission as railroads, but they are subjected to the supervision of the Commission, chiefly to prevent discrimination as to the very limited carrier service which they are allowed to perform. They are not classed as common carriers, in the same class as railroads such as the plaintiffs in these suits.

As to the Rowland Lumber Company, it entered into the business referred to in the affidavit of Mr. Turnbull not for profit, but purely for the accommodation of the community, as the following quotations from letters and documents will show:

Letter from Mr. A. R. Turnbull, President, Rowland Lumber Company to W. G. Womble, Rate Clerk, State Corporation Commission, Raleigh, N. C., March 22, 1918:

"It is true that we have been handling fertilizer over the west end of our road for the benefit of the people located in that territory. This is merely an accommodation to them, and is of no benefit to us. * * * If these people do not care for this accommodation it will certainly be a great pleasure for us, under present circumstances to discontinue this hauling of freight for them, as it is done absolutely at cost to us on the present basis."

Letter from Stevens & Beasley, Attorneys for the Rowland Lumber Company, to the North Carolina Corporation Commission, dated March 27, 1918. This letter after referring to complaints made by certain citizens of Faison, N. C., against the Rowland Lumber Company for alleged excessive charges for hauling fertilizer, says:

"The Rowland Lumber Company is not operating a logging business, over its road, this year, in Sampson County to any extent but is confining its operations to its log road in Duplin. It has not even determined to open up its road in Sampson County for the carrying of freight as charged, but was simply coming to the rescue of the farmers of Sampson County, and aiding them, as all good citizens should do, in making food for fighting Germany. For all the winter the roads in that section have been almost impassible with an empty vehicle and had the farmers, many of them 15 miles from the railroad, been permitted by the roads to have hauled at all the cost would have been enormous, from \$3 to \$5 per ton and in this emergency the Rowland Lumber Company has been helping them out at great inconvenience to itself and even a loss. Labor conditions are such the cost of operating is so high that no one except a man like Mr. Turnbull would have undertaken to deliver the fertilizer to these people and he regrets that they have been so shortsighted as to kick, for it might have been possible for the road to have been developed into a public carrier under his generous impulses and public spirit. In building the Atlantic & Carolina Railroad, he has done more for Duplin County than any other one man."

The authority granted to the Rowland Lumber Company, as aforesaid, was granted pursuant to petition filed by the Rowland Lumber Company with the Corporation Commission, copy of which is attached hereto and marked Exhibit "A," and which petition shows that it was made purely to accommodate citizens, who requested such service of the Rowland Lumber Company.

On the 27th of February, 1922, Mr. A. R. Turnbull, President of the Rowland Lumber Company, addressed another letter to Mr. W. G. Womble, Rate Clerk, Corporation Commission, in which he said:

"As you will understand we are not operating on piece of road west of Bowden, but are simply handling fertilizer, etc., for the accommodation of people in that territory. We would be money ahead by discontinuing this service, and will do so if you deem it necessary, but in the meantime, we will do the best we can to give them all the service possible. We have left one locomotive at Bowden to attend to this business and hope to give them better service this year than we have in the past. On the two points, Newton Grove and Eureka Church, however, there will be some delay, and we have notified all shippers whom we know that we do not care to handle this business except in that way."

There is attached hereto and marked Exhibit "B," a schedule of the rates of the Enterprise-Whiteville Lumber Company over its logging road, effective December 1, 1920, as filed with the Corporation Commission, which schedule shows the limitation as to the commodities carried and allowed to be carried by this road.

These logging roads and others similar to them are not classed as railroads and as full common carriers by the Corporation Commission for the reasons above shown, for the reason that their business of carriage of property of others is purely incidental to their business of logging and manufacturing lumber, and is negligible in amount, and for the reason that they maintain no regular schedule of trains, but run simply when there is particular demand

80 for a particular carriage.

R. O. SELF,

Affiant.

Subscribed and sworn to before me this 5 day of June, 1922.

[SEAL.]

W. H. PITTMAN,

Notary Public.

My commission expires July 29, 1922.

EXHIBIT "A"

Rowland Lumber Company.

Norfolk, Va., May 21, 1918.

To the Corporation Commission of North Carolina:

The Rowland Lumber Company respectfully sheweth to the Corporation Commission of North Carolina:

1. That it is a corporation incorporated under the laws of the state of North Carolina, authorized to engage in the Lumber business. In the operation of its timber it has purchased, and caused to — constructed, for logging purposes, a line of railroad running from Bowdens and Warsaw, on the Atlantic Coast Line Railroad, in Duplin County, North Carolina, in a westerly direction for about twenty miles toward Newton Grove.

2. Your petitioner has been, and is continually being, requested by the citizens living along the line of this road to transport freight for them and others; your petitioner is willing to accommodate such parties under present conditions, provided it can do so lawfully.

3. Under Revisal of 1905, Sec. 2598, as amended by Chapter 160, Laws of 1911, your Honorable Body is empowered to authorize this company to transport commodities, and to charge therefor reasonable rates, in addition to the transportation of its own commodities:

Wherefore, your petitioner respectfully prays, that your Honorable Body authorize your petitioner to transport over its logging road, as freight, commodities in carload lots, but excluding lumber and logs, purchased and used along the line of said road, and to make charges therefor; and that this authority be continued from year to year until your petitioner shall give to this Honorable Body necessary notice of its intention to discontinue said service.

Respectfully submitted,

ROWLAND LUMBER COMPANY,

(S.)

By A. R. TURNBULL,

President and General Mgr.

EXHIBIT "B."
Rate of Enterprise Lumber Company Railroad.

Effective December 1, 1920.

Fruit and vegetables, per crate.....	20	20	20	25	25	25
Fruits and vegetables, per car.....	1500	1650	1750	2000	2250	2500
Empty Crates or Barrels, ".....	1500	1650	1750	2000	2250	2500
Ditto each.....	10	10	10½	12½	15	15
Fertilizers, 20 Tons Maximum.....	2500	2600	3000	3250	3500	4000
Fertilizer from 10 to 20 tons, per ton minimum 1,500 per car.....	150	175	200	200	225	275
L. C. L. per ton.....	300	300	325	350	400	450
Cotton Seed and Hulls.....	2000	2200	2400	2700	3000	3300
L. C. L. per ton.....	200	250	300	325	375	400
Holly, Lime and Flour in carload.....	2000	2200	2400	2600	2800	3000
Wood—Minimum 10 cords, per c.....	100	100	100	110	125	150
Cotton, per bale.....	150	150	150	150	175	175
Furniture, per 100 pounds.....	25	27	30	30	30	35
Chickens and eggs.....	30	20	30	30	30	30
Mdse. not classed, per 100.....	20	20	20	25	25	30
Brick, minimum 10 per m.....	300	300	300	300	300	350

All freight is to be loaded and unloaded at expense and risk of shipper. We will not accept any freight either carload or L. C. L. from or to any point except the following:

Oliver's Siding.....	3
Taylor's Siding.....	3½
Loftin's Siding.....	3¾
King's Crossing.....	5½
Dobson's Crossing.....	7¼
Hill's or Cherry's Siding.....	9½
Scott's Store.....	12
Brown's Camp or Snow Hill.....	13
Woodland Siding C. L. only.....	16
Kornegay's Bridge " ".....	17

All cars have to — unloaded on the same day they are placed, or demurrage will be charged. No freight will be shipped collect: Package freight will be carried out only on Fridays and if placed at warehouse on any day previous to Thursday it will be held by this Company at the shipper's risk. Carload shipments will be taken out any day in the week.

ENTERPRISE LUMBER COMPANY.
THOMAS O'BERRY,

General Mgr.

83 *Affidavit of F. C. Harding.*

Filed June 20, 1922.

F. C. Harding, being duly sworn, deposes and says, that he is the President of the Greenville and Shelberdine Railroad Company; that the same was chartered in 1920; that the road is 12 miles long, extending from Greenville to Shelberdine and is of narrow gauge. That W. L. Hall is the Secretary of said Railroad Company and that David Hoots is General Superintendent, Engineer and Conductor. That this road has no office, either in Greenville or at Shelberdine or along the route of its railroad. That this road makes, as a general thing, one trip a day.

During the movement of fertilizer in the spring, it often makes two trips a day. That it carries freight for hire, from Greenville to any point along the road to Shelberdine and from Shelberdine to any point along the road to Greenville. That it issues no bills of lading. That the freight it carries from Greenville to Shelberdine, or along the route, is removed from the Atlantic Coast Line Railroad Company cars and placed in this company's car and is delivered along the route to its several patrons. That while people along the route use this road as a convenience to travel, this company has never charged any passenger rates. That this company has never made any report to the State Corporation Commission or to the Internal Revenue Commissioner and of course has never made any interstate

report as it does not do any interstate business as all of its business is intrastate. That this road is not a lumber road. It was originally built for a lumber road but when the Beaufort County Lumber Co. removed from Pitt County, the road was purchased by the present owners who afterwards incorporated under the style above named.

Affiant further states that the Greenville and Shelberdine Railroad Company does not keep its accounts according to the standard classification of accounts promulgated by the Interstate Commerce Commission.

F. C. HARDING.

Subscribed and sworn to before me this 20th day of June 1922.

M. V. HARDING,
Notary Public.

My commission expires Nov. 3, 1922.

84 *Affidavit of J. C. Nelms, Jr. (May 17, 1922).*

Filed June 20, 1922.

J. C. Nelms, Jr., being first duly sworn, deposes and says:

That he is General Auditor of Norfolk Southern Railroad Company; that during the year 1921, Norfolk Southern Railroad Company operated a line of railroad owned by Carthage & Pinchurst Railroad Company, extending from Pinchurst to Carthage, North Carolina, under a lease which had expired, the reason for the continued operation thereof being that it had been prohibited by the laws of the United States to abandon said line of railroad unless permission was granted by the Interstate Commerce Commission;

That during the year 1921, it paid as rent for the use of said property in the business or trade of Norfolk Southern Railroad Company the rent stipulated to be paid in said lease.

That Norfolk Southern Railroad Company had not taken title to and was not taking title to said property, and had no equity therein.

(S.)

J. C. NELMS, JR.

Subscribed and sworn to before me this 17th day of May 1922.

(S.)

GILBERT C. REVEILLE,
Notary Public.

[SEAL.]

My commission expires on the 31st day of August, 1924.

85 *Affidavit of J. C. Nelms, Jr. (May 18, 1922).*

In the District Court of the United States for the Eastern District of North Carolina.

ATLANTIC COAST LINE RAILROAD COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.

Affidavit.

J. C. Nelms, Jr., being first duly sworn, deposes and says:

That he is a citizen and resident of the County of Norfolk, and State of Virginia; that he is General Auditor of Norfolk Southern Railroad Company and has occupied that position since April, 1915; that he is familiar with the rules of accounting for steam and electric railroads as prescribed by the Interstate Commerce Commission.

On the 19th of May, 1914, effective July 1, 1914, the Interstate Commerce Commission issued orders classifying the accounts of steam railroads, and dividing the accounts into two classes:

- (1) Operating Revenues and Operating Expenses; and,
- (2) Income, Profit and Loss, and General Balance Sheet Accounts.

These rules are still in force, subject to such modifications and explanations as have been made by the Commission since that date.

That the order prescribing the classification of Operating Revenues and Operating Expenses of Steam Roads, among other things provided:

"It is ordered, That, the Classification of Operating Revenues and Operating Expenses of Steam Roads and the text pertaining thereto, embodied in printed form to be hereafter known as Issue of 1914, a copy of which is now before this Commission, be, and is hereby, approved; that a copy thereof duly authenticated by the Secretary of the Commission be filed in its archives, and a second copy thereof, in like manner authenticated, in the office of the Division of Carriers' Accounts; and that each of said copies so authenticated and filed shall be deemed an original record thereof.

"It is further ordered, That the said Classification of Operating Revenues and Operating Expenses of Steam Roads, with the text pertaining thereto, be, and is hereby, prescribed for the use of carriers by rail (exclusive of electric railways) subject to the provisions of the Act to Regulate Commerce as amended, in the keeping and recording of their operating revenue and operating expense accounts; that each and every such carrier and each and every receiver or operating trustee of any such carrier be required to

keep all operating revenue and operating expense accounts in conformity therewith; and that a copy of said issue be sent to each and every such carrier and to each and every receiver or operating trustee of any such carrier."

This affiant has a copy of the said order and the classification of accounts and instructions accompanying the same.

Accompanying said order, as sent to the carriers, was an introductory letter, which among other things stated that:

"Accounts are provided in this classification for the revenues and expenses of operations which heretofore have been classed as auxiliary or outside operations. The purpose in merging these accounts has been to secure a statement of revenues and expenses in connection with the operation of all physical property the cost of which is includible in the accounts for investment in road and equipment. The accounts for maintenance of physical property have been arranged to correspond with those for the investment in such property. Depreciation accounts have been provided for the current depreciation of fixed improvements, although until further directed the recognition in operation expenses of current depreciation of fixed improvements is optional with the carrier. It is provided that organization and general administration expenses directly assignable to investments in stocks, bonds, and other securities shall be excluded from the accounts of this classification and included in income account No. 549, "Maintenance of investment organization."

There also accompanied said order and classification certain general instructions, among which were the following:

"1. Operating Accounts.—The accounts of this classification are designed to show the revenues and expenses (including the maintenance of the facilities used) of the carrier's railway operations, including rail-line transportation, water-line transportation, if any, and services incident to transportation. Transportation includes the receipt, conveyance, and delivery of traffic."

"4. Miscellaneous Operations.—The revenue and expenses of miscellaneous operations involving the use of such facilities as hotels and restaurants, power plants, cold-storage plants, *coal-storage plants*, cotton compress plants, wood-preserving plants, ice-supply plants, etc., shall not be included in the accounts of this classification when the facilities used are distinct from those used by the carrier in the service of transportation or in the maintenance of facilities used in transportation service, and the operations are not incident to such service. (See income accounts No. 502, "Revenue from miscellaneous operations," and No. 534, "Expenses of miscellaneous operations," and balance-sheet account No. 705, "Miscellaneous physical property.")"

There also accompanied said order certain special instructions, among which was:

"1. Accounts for Operating Revenues.—The accounts provided for operating revenues are designed to show amounts of money which a carrier becomes entitled to receive from transportation and from operations incident thereto."

The Operating Revenue accounts were by the said classification divided into general accounts and primary accounts. A statement of the general accounts and primary accounts for steam railroads, according to the said classification, showing the number of each account, as set out in said rule and order is hereto attached marked Exhibit A and prayed to be taken as a part of this affidavit.

The said order prescribed that account 142 "Rents of Buildings and other property," should include: "the revenue from the exclusive use of buildings and other property or portions thereof, such as depot and station grounds and buildings, general and other offices, wharves, ferry landings, elevators, stockyards, fuel yards, enginehouses, repair shops, and section and other houses, when the property is operated and maintained in connection with the property used in the carrier's transportation operations and the expenses of maintaining and operating the rented portion cannot be separated from the expenses of that portion used by the carrier."

As to the General Account No. IV, Joint Facility, being primary accounts Nos. 151 and 152, the said order provides that these accounts should include the carrier's proportion of revenue collected by others in connection with the operation of joint tracks, yards, terminals and other facilities, and also that proportion of revenue from the operation of joint tracks, yards terminals and other facilities, which is creditable to other companies.

The account did not include the rent paid for the use of the joint facilities, simply results of operations.

The operating expenses were by said order divided into eight general accounts, and into quite a number of primary accounts. A statement is hereto attached showing the general and primary accounts of steam railroads. Said statement is marked Exhibit B and is prayed to be taken as a part hereof.

The special instructions accompanying said order, among other things, stated that: "The accounts prescribed for operating expenses are designed to show expenses of furnishing transportation service, including the expenses of maintaining the plant used in the service."

The accounts of Norfolk Southern Railroad Company are and have been kept in accordance with the rules and regulations prescribed by the Interstate Commerce Commission as set out in said orders, as explained by the instructions and orders of the Commission, modifying or explaining the aforesaid order of May 19, 1914.

The said accounts and reports made to the Commission in accordance with said rules and regulations do not contain any such term as "Net Operating Income." The reports of Norfolk Southern Railroad Company made to the Interstate Commerce Commission show

the total amount of its operating revenues and also shows the total amount of its operating expenses, and also the difference between these two amounts, which in said reports, and under the rules prescribed by the Interstate Commerce Commission, is denominated and known as "Net Revenue from Railway Operations." The Net Revenue from Railway Operations of Norfolk Southern Railroad Company and of corporations operating steam or electric railroads, keeping their accounts in accordance with the standard classification of accounting of the Interstate Commerce Commission, is the difference between the amount of money which Norfolk Southern Railroad Company or such other similar corporations, receives from transportation, as the term "Transportation" is defined in the said classification of accounts and in the Interstate Commerce Act, and the amount paid out for "all the ordinary and necessary expenses paid during the income year for conducting and carrying on transportation, as transportation is defined in the said classification of accounts and in the Interstate Commerce Act, including as a part of said expenses depreciation on its equipment, to-wit: steam locomotives, other locomotives, freight train cars, passenger train cars, motor equipment of cars, floating equipment, work equipment and miscellaneous equipment, if any."

Accounts of operating revenues and operating expenses of steam railroads, such as Norfolk Southern Railroad Company, and other similar corporations, kept in accordance with standard classification of accounting of the Interstate Commerce Commission do not include all gain derived from capital or labor or both combined, provided it is understood that the term "gain" includes profit gained through a sale or conversion of capital assets.

The said operating revenues and operating expenses of steam roads does not include the following items of gain or income which such corporations may receive during any period of time, but said items or sources of revenue or gain are in accordance with said classification carried under what is known as income accounts, to-wit: revenues from miscellaneous operations, hire of freight cars, credit balance, rents from locomotives, rents from passenger train cars, rents

89 from floating equipment, rents from work equipment, joint facility rent income, income from lease of road, miscellaneous rent income, miscellaneous non-operating physical property, separately operated properties,—profit, dividend income, income from funded securities, income from unfunded securities and accounts, income from sinking and other reserve funds, release of premiums on funded debt, contributions from other companies, and miscellaneous income, all of which are gain from labor or capital or both combined, or from a sale or conversion of capital assets.

The accounts of operating revenues and operating expenses of steam railroads, when such accounts are kept in accordance with the standard classification of accounting of Interstate Commerce Commission, do not include all of the expenses of conducting and carrying on the business of the corporation, and do not include many items of

expenses which are necessary to be paid in order that the business may be carried on, to-wit: railway tax accruals; uncollectible railway revenues; expenses of miscellaneous operations; taxes on miscellaneous operating property; hire of freight cars—debit balance; rent for locomotives; rent for passenger-train cars; rent for floating equipment; rent for work equipment; joint facility rents; rent for leased roads; miscellaneous rents; miscellaneous tax accruals; separately operated properties—loss; interest on funded debt; interest on unfunded debt; amortization of discount on funded debt; maintenance of investment organization; income transferred to other companies; miscellaneous income charges; income applied to sinking and other reserve funds; dividend appropriations of income; income appropriated for investment in physical property; stock discount extinguished through income; and miscellaneous appropriations of income.

Under the aforesaid orders of the Interstate Commerce Commission dividing the accounts of corporations, operating steam railroads engaged in interstate commerce, into the two general classes as aforesaid, to-wit: Operating Revenues and Operating Expenses on the one part, and Income, Profit and Loss, and General Balance Sheet Accounts on the other, the Interstate Commerce Commission prescribed with great care and particularity the items of revenue which should go into each of the income accounts both credit and debit accounts.

A list of the primary accounts constituting the income accounts under said classification, both credit and debit is hereto attached, marked Exhibit C and prayed to be taken as a part hereof.

In addition, the said order of the Commission in prescribing rules of accounting for corporations operating steam railroads engaged in interstate commerce, prescribed a form of income statement. A copy of said form is hereto attached and made a part hereof, marked Exhibit D, and prayed to be taken as a part hereof.

90 The accounts of Norfolk Southern Railroad Company are kept in accordance with the aforesaid classification, its income statement is made to accord with the form of income statement prescribed in said rules of accounting and it reports to the Interstate Commerce Commission its operating revenues, operating expenses, other items of intake and outgo, all as prescribed by the Interstate Commerce Commission.

The term "Operation Ratio" does not appear in said rules of accounting. The term "operating ratio" is generally understood to mean and be that percent which the operating expenses as prescribed by the Interstate Commerce bears to the operating revenues as prescribed by the Interstate Commerce Commission.

The difference between the operating revenue and operating expenses of a corporation operating the steam railroads in keeping its accounts in accordance with the rules of the Interstate Commerce Commission does not show or purport to show the net income of such corporations, but purports to show and shows the difference between the amount of revenue received from the business of conducting and carrying on its transportation and the operations incident thereto and the cost and expense of conducting such transportation and the incidents thereto.

In order to obtain the net income of such corporations it is necessary to consider and take into consideration the income accounts of said corporation as prescribed and shown in the rules of accounting of the Interstate Commerce Commission, and is set out in the form of income statement prescribed by the Commission, and which such railroad companies are required to make to the Commission.

Norfolk Southern Railroad Company owns and operates a line of electric railroad which runs from Norfolk to Virginia Beach and thence to Cape Henry, thence returning to Norfolk. In making reports to the Interstate Commerce Commission under the orders of the Commission the accounts of the electric division and the steam division are combined. Under permission granted by the Interstate Commerce Commission, Norfolk Southern Railroad Company keeps records showing the accounts of the electric division or electric railroad separate from the steam division or steam railroad. No part of the electric railroad is situated in North Carolina. The steam railroad extends and is situated both in North Carolina and Virginia. The ratio of operating expenses to operating revenue of the electric division was for the year 1921, 74.37% and for the steam division 84.51%, and for the entire system including both steam and electric divisions, 83.81%. That is to say that out of every dollar received by Norfolk Southern Railroad Company in payment for services rendered in the conduct of transportation on its electric division, as transportation is defined in classification of accounts of the Interstate Commerce Commission, it paid out in operating expenses, as

91 such operating expenses are defined in said classification of accounts, 74.37 cents. That or its steam division, which is located partly in North Carolina and partly in Virginia, where the business is both local and through, in both states, out of every dollar taken in for services rendered in the conduct of transportation, both intra and interstate, it became necessary to pay, and the company did pay in operating expenses as operating expenses are defined in said classification, the sum of 84.51 cents. That considering its entire system, both electric and steam, out of every dollar taken in payment for services rendered in transportation, both interstate and intrastate, as transportation is defined in the standard classification of accounting of the Interstate Commerce Commission, it becomes necessary for Norfolk Southern Railroad Company to pay for operating expenses in conducting transportation, as transportation is defined in the classification of accounting of the Interstate Commerce Commission 83.81 cents.

That in addition to the operating expenses aforesaid it became necessary for Norfolk Southern Railroad Company, in order to conduct and carry on its business and especially its business on steam division, to pay sums and items as set out in section 23 of the bill of complaint filed in this case.

During the calendar year 1921, which was the income year 1921, Norfolk Southern Railroad Company paid expenses for conducting and carrying on its business which are not included under the head of operating expenses under the rules of accounting of the Interstate Commerce Commission, as follows, to-wit:

Joint Facility Rents, that is rents for tracks, yards, terminals and other facilities owned or controlled by other carriers, companies or individuals, and in the joint use of which Norfolk Southern Railroad Company participated, in the sum of \$37,366.96 of which \$34,009.76 was allocatable to that part of the road located in North Carolina.

For rent of roads, tracks or bridges, including equipment and other railway property covered by the contract of lease of other companies held under lease or other agreement, by the terms of which the exclusive use and control for operating purposes are secured, the sum of \$160,365.96, the entire amount of which was for properties located in North Carolina.

For the use of miscellaneous property, that is property which was not used in the operation of the railroad, but used in the conduct of its business and necessary so to be used, the sum of \$1,376.63 of which \$372.83 was allocatable to North Carolina.

For interest on its funded debt the sum of \$884,399.57 of which \$778,351.22 was and is allocatable to the State of North Carolina.

For interest on unfunded debt \$37,025.96, of which \$32,587.06 is allocatable to North Carolina.

For amortization of discount on funded debt, being a proportion of the discount and expense on funded debt of the company applicable to that period, in accordance with the standard rules of accounting of the Interstate Commerce Commission \$24,719.53 of which \$21,755.41 was and is allocatable to North Carolina.

Other expenses of conducting and carrying on its business which, in the standard classification of accounting of the Interstate Commerce Commission is designated as miscellaneous income charges, the sum of \$57,897.34, of which \$50,778.85 is allocatable to the State of North Carolina.

That Norfolk Southern Railroad Company had not taken title, was not taking title, and had no equity in any of the properties leased, including the railroads or joint facilities, and which are referred to as having been secured for its use in the conduct of its business by payment of the rents aforesaid.

That under the orders of the Commission, the form of accounting prescribed for operating expenses carried accounts "for the current depreciation of fixed improvements." The said orders and instructions further provided that the recognition of and charging out in operating expenses current depreciation of fixed improvements is and was optional with the carrier. Norfolk Southern Railroad Company has never charged out in its operating expenses any current depreciation for fixed improvements.

(S)

J. C. NELMS, JR.

Sworn and subscribed to before me this 18 day of May, 1922.

(S)

GILBERT C. REVEILLE.

[SEAL.]

Notary Public.

My commission expires on the 31st day of August, 1924.

EXHIBIT A.

Operating Revenue Accounts.

General Accounts.

- I. Transportation—Rail Line.
- II. Transportation—Water Line.
- III. Incidental.
- IV. Joint Facilities.

Primary Accounts.

I. Transportation—Rail line:

- 101. Freight.
- 102. Passenger.
- 103. Excess baggage.
- 104. Sleeping car.
- 105. Parlor and chair car.
- 106. Mail.
- 107. Express.
- 108. Other passenger-train.
- 109. Milk.
- 110. Switching.
- 111. Special service train.
- 112. Other freight-train.
- 113. Water transfers—Freight.
- 114. Water transfers—Passenger.
- 115. Water transfers—Vehicles and live stock.
- 116. Water transfers—Other.

II. Transportation—Water line—

- 121. Freight.
- 122. Passenger.
- 123. Excess baggage.
- 124. Other passenger service.
- 125. Mail.
- 126. Express.
- 127. Special service.
- 128. Other.

III. Incidental—

- 131. Dining and buffet.
- 132. Hotel and restaurant.
- 133. Station, train, and boat privileges.
- 134. Parcel room.
- 135. Storage—Freight.
- 136. Storage—Baggage.

- 137. Demurrage.
- 138. Telegraph and telephone.
- 139. Grain elevator.
- 140. Stockyard.
- 141. Power.
- 142. Rents of buildings and other property.
- 143. Miscellaneous.

IV. Joint Facility—

- 151. Joint Facility—Cr.
- 152. Joint Facility—Dr.

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EXHIBIT B.

Operating Expense Accounts.

General Accounts.

- I. Maintenance of Way and Structures.
- II. Maintenance of Equipment.
- III. Traffic.
- IV. Transportation—Rail line.
- V. Transportation—Water line.
- VI. Miscellaneous operations.
- VII. General.
- VIII. Transportation for investment—Cr.

Primary Accounts.

I. Maintenance of Way and Structures—

- 201. Superintendence.
- 202. Roadway maintenance.
- 203. Roadway—Depreciation.
- 204. Underground power tubes.
- 205. Underground power tubes—Depreciation.
- 206. Tunnels and subways.
- 207. Tunnels and subways—Depreciation.
- 208. Bridges, trestles, and culverts.
- 209. Bridges, trestles, and culverts—Depreciation.
- 210. Elevated structures.
- 211. Elevated structures—Depreciation.
- 212. Ties.
- 213. Ties—Depreciation.
- 214. Rails.
- 215. Rails—Depreciation.
- 216. Other track material.
- 217. Other track material—Depreciation.
- 218. Ballast.
- 219. Ballast—Depreciation.

220. Track laying and surfacing.
221. Right-of-way fences.
222. Right-of-way fences—Depreciation.
223. Snow and sand fences and snowsheds.
224. Snow and sand fences and snowsheds—Depreciation.
225. Crossings and signs.
226. Crossings and signs—Depreciation.
227. Stations and office buildings.
228. Stations and office buildings—Depreciation.
229. Roadway buildings.
230. Roadway buildings—Depreciation.
231. Water stations.
232. Water stations—Depreciation.
233. Fuel stations.
234. Fuel stations—Depreciation.
235. Shops and enginehouses.
236. Shops and enginehouses—Depreciation.
- 95 237. Grain elevators.
238. Grain elevators—Depreciation.
239. Storage warehouses.
240. Storage warehouses—Depreciation.
241. Wharves and docks.
242. Wharves and docks—Depreciation.
243. Coal and ore wharves.
244. Coal and ore wharves—Depreciation.
245. Gas producing plants.
246. Gas producing plants—Depreciation.
247. Telegraph and telephone lines.
248. Telegraph and telephone lines—Depreciation.
249. Signals and interlockers.
250. Signals and interlockers—Depreciation.
251. Power plant dams, canals, and pipe lines.
252. Power plant dams, canals, and pipe lines—Depreciation.
253. Power plant buildings.
254. Power plant buildings—Depreciation.
255. Power substation buildings.
256. Power substation buildings—Depreciation.
257. Power transmission systems.
258. Power transmission systems—Depreciation.
259. Power distribution systems.
260. Power distribution systems—Depreciation.
261. Power line poles and fixtures.
262. Power line poles and fixtures—Depreciation.
263. Underground conduits.
264. Underground conduits—Depreciation.
265. Miscellaneous structures.
266. Miscellaneous structures—Depreciation.
267. Paving.
268. Paving—Depreciation.
269. Roadway machines.

- 270. Roadway machines—Depreciation.
- 271. Small tools and supplies.
- 272. Removing snow, ice and sand.
- 273. Assessments for public improvements.
- 274. Injuries to persons.
- 275. Insurance.
- 276. Stationery and printing.
- 277. Other expenses.
- 278. Maintaining joint tracks, yards, and other facilities—
Dr.
- 279. Maintaining joint tracks, yards, and other facilities—
Cr.

II. Maintenance of Equipment—

- 301. Superintendence.
- 302. Shop machinery.
- 303. Shop machinery—Depreciation.
- 304. Power plant machinery.
- 305. Power plant machinery—Depreciation.
- 306. Power substation apparatus.
- 307. Power substation apparatus—Depreciation.
- 308. Steam locomotives—Repairs.
- 309. Steam locomotives—Depreciation.
- 310. Steam locomotives—Retirements.
- 311. Other locomotives—Repairs.
- 312. Other locomotives—Depreciation.
- 313. Other locomotives—Retirements.
- 314. Freight-train cars—Repairs.
- 315. Freight-train cars—Depreciation.
- 316. Freight-train cars—Retirements.
- 317. Passenger-train cars—Repairs.
- 318. Passenger-train cars—Depreciation.
- 319. Passenger-train cars—Retirements.
- 320. Motor equipment of cars—Repairs.
- 321. Motor equipment of cars—Depreciation.
- 322. Motor equipment of cars—Retirements.
- 323. Floating equipment—Repairs.
- 324. Floating equipment—Depreciation.
- 325. Floating equipment—Retirements.
- 326. Work equipment—Repairs.
- 327. Work equipment—Depreciation.
- 328. Work equipment—Retirements.
- 329. Miscellaneous equipment—Repairs.
- 330. Miscellaneous equipment—Depreciation.
- 331. Miscellaneous equipment—Retirements.
- 332. Injuries to persons.
- 333. Insurance.
- 334. Stationery and printing.
- 335. Other expenses.
- 336. Maintaining joint equipment at terminals—Dr.
- 337. Maintaining joint equipment at terminals—Cr.

III. Traffic—

- 351. Superintendence.
- 352. Outside agencies.
- 353. Advertising.
- 354. Traffic associations.
- 355. Fast freight lines.
- 356. Industrial and immigration bureaus.
- 357. Insurance.
- 358. Stationery and printing.
- 359. Other expenses.

IV. Transportation—Rail line—

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- 371. Superintendence.
- 372. Dispatching trains.
- 373. Station employees.
- 374. Weighing, inspection, and demurrage bureaus.
- 375. Coal and ore wharves.
- 376. Station supplies and expenses.
- 377. Yardmasters and yard clerks.
- 378. Yard conductors and brakemen.
- 379. Yard switch and signal tenders.
- 380. Yard enginemen.
- 381. Yard motormen.
- 382. Fuel and yard locomotives.
- 383. Yard switching power produced.
- 384. Yard switching power purchased.
- 385. Water for yard locomotives.
- 386. Lubricants for yard locomotives.
- 387. Other supplies for yard locomotives.
- 388. Enginehouse expenses—Yard.
- 389. Yard supplies and expenses.
- 390. Operating joint yards and terminals—Dr.
- 391. Operating joint yards and terminals—Cr.
- 392. Train enginemen.
- 393. Train motormen.
- 394. Fuel for train locomotives.
- 395. Train power produced.
- 396. Train power produced purchased.
- 397. Water for train locomotives.
- 398. Lubricants for train locomotives.
- 399. Other supplies for train locomotives.
- 400. Enginehouse expenses—Train.
- 401. Trainmen.
- 402. Train supplies and expenses.
- 403. Operating sleeping cars.
- 404. Signal and interlocker operation.
- 405. Crossing protection.
- 406. Drawbridge operation.
- 407. Telegraph and telephone operation.
- 408. Operating floating equipment.

- 409. Express service.
- 410. Stationery and printing.
- 411. Other expenses.
- 412. Operating joint tracks and facilities—Dr.
- 413. Operating joint tracks and facilities—Cr.
- 414. Insurance.
- 415. Clearing wrecks.
- 416. Damage to property.
- 417. Damage to live stock on right of way.
- 418. Loss and damage—Freight.
- 419. Loss and damage—Baggage.
- 420. Injuries to persons.

V. Transportation—Water line—

- 431. Operation of vessels.
- 432. Operation of terminals.
- 433. Incidental.

VI. Miscellaneous operations—

- 441. Dining and buffet service.
- 442. Hotels and restaurants.
- 443. Grain elevators.
- 444. Stockyards.
- 445. Producing power sold.
- 446. Other miscellaneous operations.

VII. General—

- 451. Salaries and expenses of general officers.
- 452. Salaries and expenses of clerks and attendants.
- 453. General office supplies and expenses.
- 454. Law expenses.
- 455. Insurance.
- 456. Relief department expenses.
- 457. Pensions.
- 458. Stationery and printing.
- 459. Valuation expenses.
- 460. Other expenses.
- 461. General joint facilities—Dr.
- 462. General joint facilities—Cr.

VIII. Transportation for investment—Cr.

EXHIBIT C.

Income Accounts.

Primary Accounts.

I. Credits:

- 501. Railway operating revenues.
- 502. Revenues from miscellaneous operations.

- 503. Hire of freight cars—Credit balance.
- 504. Rent from locomotives.
- 505. Rent from passenger-train cars.
- 506. Rent from floating equipment.
- 507. Rent from work equipment.
- 508. Joint facility rent income.
- 509. Income from lease of road.
- 510. Miscellaneous rent income.
- 511. Miscellaneous non-operating physical property.
- 512. Separately operated properties—Profit.
- 513. Dividend income.
- 514. Income from funded securities.
- 515. Income from unfunded securities and accounts.
- 516. Income from sinking and other reserve funds.
- 517. Release of premiums on funded debt.
- 518. Contributions from other companies.
- 519. Miscellaneous income.

II. Debits:

- 531. Railway operating expenses.
- 532. Railway tax accruals.
- 533. Uncollectible railway revenues.
- 534. Expenses of miscellaneous operations.
- 535. Taxes on miscellaneous operating property.
- 536. Hire of freight cars—Debit balance.
- 537. Rent for locomotives.
- 538. Rent for passenger-train cars.
- 539. Rent for floating equipment.
- 540. Rent for work equipment.
- 541. Joint facility rents.
- 542. Rent for leased roads.
- 543. Miscellaneous rents.
- 544. Miscellaneous tax accruals.
- 545. Separately operated properties—Loss.
- 546. Interest on funded debt.
- 547. Interest on unfunded debt.
- 548. Amortization of discount on funded debt.
- 549. Maintenance of investment organization.
- 550. Income transferred to other companies.
- 551. Miscellaneous income charges.
- 552. Income applied to sinking and other reserve funds.
- 553. Dividend appropriations of income.
- 554. Income appropriated for investment in physical property.
- 555. Stock discount extinguished through income.
- 556. Miscellaneous appropriations of income.

EXHIBIT D.

Form of Income Statement.

I. Operating income—

- 501. *Railway operating revenues.
- 531. *Railway operating expenses.
- *Net revenues from railways operations.
- 532. *Railway tax accruals.
- 533. *Uncollectible railway revenues.
- *Railway operating income.
- 502. Revenues of miscellaneous operations.
- 534. Expenses of miscellaneous operations.
- Net revenue from miscellaneous operations.
- 535. Taxes on miscellaneous operating property.
- Miscellaneous operating income.
- Total operating income.

II. Non-operating Income—

- 503. Hire of freight cars—Credit balance.
- 504. Rent from locomotives.
- 505. Rent from passenger-train cars.
- 506. Rent from floating equipment.
- 507. Rent from work equipment.
- 508. Joint facility rent income.
- 509. Income from lease of road.
- 510. Miscellaneous rent income.
- 511. Miscellaneous non-operating physical property.
- 512. Separately operated properties—Profit.
- 513. Dividend income.
- 514. Income from funded securities.
- 515. Income from unfunded securities and accounts.
- 516. Income from sinking and other reserve funds.
- 517. Release of premiums on funded debt.
- 518. Contributions from other companies.
- 519. Miscellaneous income.
- Total non-operating income.
- Gross income (or loss).

III. Deductions from gross income:

- 536. Hire of freight cars—Debit balance.
- 537. Rent for locomotives.
- 538. Rent for passenger-train cars.
- 539. Rent for floating equipment.
- 540. Rent for work equipment.
- 541. Joint facility rents.

*Includes operations of water lines, if any.

- 542. Rent for leased roads.
- 543. Miscellaneous rents.
- 544. Miscellaneous tax accruals.
- 545. Separately operated properties—Loss.
- 546. Interest on funded debt.
- 101 547. Interest on unfunded debt.
- 548. Amortization of discount on funded debt.
- 549. Maintenance of investment organization.
- 550. Income transferred to other companies.
- 551. Miscellaneous income charges.
- Total deductions from gross income.
- Net income (or loss).

IV. Disposition of Net Income:

- 552. Income applied to sinking and other reserve funds.
- 553. Dividend appropriations of income.
- 554. Income appropriated for investment in physical property.
- 555. Stock discount extinguished through income.
- 556. Miscellaneous appropriations of income.
- Total appropriations.
- Income balance transferred to credit (or debit) of Profit and Loss.

102 *Affidavit of J. C. Nelms, Jr. (June 12, 1922).*

Filed June 20, 1922.

J. C. Nelms, Jr., being first duly sworn, deposes and says: that, Accompanying and constitution a part of the order of the Interstate Commerce Commission, made the 19th of May, 1914, effective July 1st, 1914, and still in force, with such modifications and amendments as may have been made thereto, were certain special instructions of which No. — reads as follows:

"Income accounts are these designed to show, as nearly as practicable, for each fiscal period, the total amount of money that a carrier becomes entitled to receive for services rendered, the returns accrued upon investments, the accrued costs paid or payable for the services rendered by it, the losses sustained by it, the amounts accrued for taxes, for use of moneys and for use of properties of others, and the appropriations made from income during the period. The net balance of income (or less) shall be carried to Profit and Loss."

The order above referred to is the order of the Commission regulating the keeping of records by Interstate Carriers by Railroad, known as "Classification of Income, Profit and Loss, and General Balance Sheet Accounts for Steam Roads."

J. C. NELMS, JR.

Sworn and subscribed to before me this 12th day of June, 1922.

GILBERT C. REVEILLE,

Notary Public.

My commission expires the 31st day of August, 1924.

103 *Testimony of R. O. Self at Hearing Before Judge Connor.*

It is agreed that all affidavits filed in the cause by either of the plaintiffs or by the defendants will be treated as in evidence in all cases.

Mr. R. O. Self, Clerk of the North Carolina Corporation Commission produced a list of the corporations operating as limited common carriers in North Carolina under authority granted by the State Corporation Commission under section 3413 of the Consolidated Statutes of North Carolina. Also a memorandum adding two others roads was attached, all filed as Exhibit A.

R. O. SELF, witness for the defendant, examined by Judge Manning, testifies as follows:

That the several roads mentioned in Exhibit A were lumber roads, for logging purposes, operating under Section 3413 of the Consolidated Statutes as a limited carrier, with the right to stop at anytime.

104 *Exhibit "A" to Testimony of R. O. Self.*

STATE OF NORTH CAROLINA:

Office of the Corporation Commission.

This is to certify, that the Corporation Commission of North Carolina, acting under power vested in it by Sec. 3413 of the Consolidated Statutes of North Carolina, has granted authority to the corporations named below to conduct and carry on the business of limited common carriers between the points designated as to each of the corporations named, and that said corporations have filed with the Corporation Commission of North Carolina tariffs establishing the rate of charges which they are authorized to make for the transportation of commodities between the points named.

The corporations named and the points between which they are authorized to act as limited common carriers, engaged in Intra-state Commerce in North Carolina over a line of steam railroad, are as follows:

Andrews Manufacturing Company, Between Andrews and Old Road Gap, a distance of 8 miles, or thereabouts.

Carr Lumber Company, Between Pisgah Forest and Vanderbilt Boundary, a distance of about 20 miles.

Empire Manufacturing Company, Between Oliver Station to within three miles of Bentonville, about 13 miles.

Enterprise Lumber Company, Between Mount Olive and New Camp, a distance of 18 miles, or thereabouts.

Fishing Creek Timber & Railroad Company, Between Stamper, N. C., and Coffield's Bridge, about 10 miles.

Carolina Southern Railroad, Between Hollister and Vaughan, a distance of 14½ miles, or thereabouts.

105 Montgomery Lumber Company, Between Spring Hope and Bunn, N. C., a distance of 10 miles, or thereabouts.

Oeona Lufty Railroad Company, Between Oeona Lufty, N. C. and Smokemont, N. C., about 10 miles.

Rowland Lumber Company, Between Bowdens, N. C., and Warsaw, N. C., toward Newton Grove, a distance of about 20 miles.

Waccamew Lumber Company, Between Bolton and Makatoka, a distance of about 18 miles.

Weldon Lumber Company, Between Weldon, N. C., and a point near Ringwood, a distance of about 20 miles.

Whiteville Lumber Company, Between Whiteville, N. C., and Buttler, a distance of about 27 miles.

Mill Creek Valley Railroad Between — and — a distance of about — miles.

Suncrest Lumber Co., Sunburst to Canton.

Hilton Railroad & Logging Co., Hilton Creek to Island Creek, 6 miles.

Done at the office of the Corporation Commission, at Raleigh, on that the — day of May 1922, by the Corporation Commission, through W. T. Lee, its Chairman, and under the seal of the said Commission.

106 *Testimony of C. J. Joseph at Hearing Before Judge Connor*

C. J. JOSEPH, Tax Agent of the A. C. L. Railroad, witness for the Plaintiff, examined by Mr. Thomas W. Davis, testifies as follows:

That he had for a great many years been the tax agent of that road, with the duty of checking and looking after all the taxes of that Company and its affiliated lines in Virginia, North and South Carolina, Georgia, Florida and Alabama. That he was familiar with this litigation and with the Income Tax Laws of North Carolina; that he has to keep up with the stocks and bonds and statistics of the various roads mentioned; that he is familiar with the commercial and Financial Chronicle, a financial trade paper, circulated throughout the United States, that collects statistics as to capitalization and earnings of the various railroads and industrial corporations and their stocks and bonds. The issue of May 27, 1922 of that paper was offered in evidence, and Mr. Davis desired to read into the record the capital stock and bonds of certain industrial corporations reporting to the North Carolina Tax Commission, the Tax Commission showing the capital, but not the bonds issued by them.

107 *EXHIBIT TO TESTIMONY OF C. J. JOSEPH.*

Representative Partial List of Industrial Corporations Doing Business in North Carolina and Reporting to the North Carolina Corporation Commission and Commissioner of Revenue Financed by Bonds and Stocks.

American Agricultural Chemical Company:

Common stock	\$33,322.12
Preferred Stock	28,455.20
First Mortgage bonds	6,252,000
1st Ref. Mortgage s. f. gold bonds, Series "A", ..	30,000,000

American Sugar Refining Company:

Common Stock	45,000,000
Preferred Stock	45,000,000
15 Year Gold Bonds	30,000,000

American Tobacco Company:

Common Stock "A"	40,242,400
Common Stock "B"	49,344,200
Preferred Stock	52,699,700
Gold Bonds	371,950
Gold Bonds & Cons. Tobacco Collateral Trust Trust Mortgage Bonds	1,365,300
Series of Gold Notes	10,000,000
8% Dividend Certificates	8,058,831

Dupont, I. E., de Nemours & Company:

Common stock	63,378,300
Debenture Stock	71,243,250
10 Year Gold Bonds	35,000,000

Galena Signal Oil Company:

Common Stock	16,000,000
Preferred Stock	2,000,000
New Preferred Stock	4,000,000
Convertible Debenture	6,000,000
Entire Stock of Subsidiary Companies	2,800,000
Galena Signal Oil of Texas Bonds	2,800,000

General Electric Company:

Common Stock	176,329,100
Debenture for Sprague Stock	2,047,000
Debenture	15,136,500
Debenture Bonds	15,000,000

Kelly Springfield Tire Company:

Common Stock	\$9,096,002
Preferred Stock	3,137,100
Second Preferred	5,625,200
10 Year s. f. Gold Notes	10,000,000

Morris Company:

1st Mortgage	17,626,000
10 Year s. f. Gold Notes	15,000,000
Wm. F. Mosser Co. 10 yr. s. f. notes	3,000,000

Swift & Company:

Common Stock	150,000,000
1st Mortgage s. f. Gold Bonds	28,923,500
Gold Notes	65,000,000

Texas Company:

Stock	164,450,000
3 yr. S. F. Notes	22,772,000

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Final Decree.

Filed Nov. 13, 1922.

In the District Court of the United States for the Eastern District of
North Carolina, Raleigh Division.

Equity. No. 448.

ATLANTIC COAST LINE RAILROAD COMPANY

vs.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, and
JAMES S. MANNING, Attorney General of North Carolina.

Decree.

This is a suit in equity, brought by plaintiff, Norfolk Southern Railroad Company, a corporation chartered and organized under the laws of the State of Virginia, operating a line of railway in and through the State of North Carolina and the Eastern District thereof, against defendant, A. D. Watts, individually, and as Commissioner of Revenue of North Carolina and James S. Manning, Attorney General of said State, seeking an injunction restraining and enjoining said defendants from taking or causing to be taken any action toward enforcing the filing of a return or the collection of a tax or any part thereof, imposed, or sought to be imposed by the State of North Carolina, upon the plaintiff, under or by virtue of the provisions of the Public Laws of North Carolina of 1921, Chapter 34, known as the Revenue Act or the Income Tax Act, as amended by the General Assembly of North Carolina at its Special Session of 1921.

Following the service of process on the defendants and filing answer to the bill, the cause was set down for hearing upon the bill, answer and evidence.

Plaintiff alleges that, by the provisions of Article 5, Section 3 of the Constitution of North Carolina, the General Assembly is authorized to pass laws.

"Taxing, by a uniform rule, all moneys, credits, investments in bonds, stocks, joint-stock companies, or otherwise, and also real and

personal property, according to its true value in money. * * *

The General Assembly may also tax trades, professions and incomes.

110 Provided the rate of tax on incomes shall not, in any case, exceed six per cent, and there shall be allowed the following exemptions, to be deducted from the amount of annual incomes to-wit: For a married man, with a wife living with him, or to widow or widower having minor child or children, natural or adopted, not less than \$2,000.00; to all other persons not less than \$1,000; and there may be allowed other deductions (not including living expenses), so that net incomes are taxed."

Pursuant to the provisions of the foregoing Art. of the Constitution, the General Assembly, at its Session of 1921, enacted a statute providing for levying, collecting and paying an income tax on individuals and corporations. Chap. 34 Public Laws of North Carolina and known as a part of the Revenue Act of 1921, or, so far as it relates to the Income Tax, as the "Income Tax Act of 1921."

The sections of this Act pertinent to the questions presented for decision by the plaintiff's contention are:

Section 101. Purpose.—

"The general purpose of this act is to impose a tax for use of the State Government, upon the net income for the calendar year 1921, in excess of exemptions herein set out, collectible in the year 1922 and annually thereafter:

(a) Of every citizen of the State.

(b) Of every domestic corporation.

(c) Of every foreign corporation and of every non resident individual having a business or agency in this State in proportion to the net income of such business or agency.

"Except as otherwise provided in this Act, the purpose is to conform to the definitions of income in the revenue laws of the United States Government and regulations made under its authority in so far as they apply."

"The tax imposed upon the net income of corporations in this schedule is in addition to the tax imposed under Schedule "C" of this Act."

Section 201. Corporations.—

Every corporation organized under the laws of this State shall pay annually an income tax equivalent to three per cent of the entire net income of such corporation, as herein defined, received by such corporation during the income year; and every foreign corporation doing business in this State shall pay annually an income tax equivalent to three per cent of a proportion of its entire net income, to be determined according to the following rules.

In case of a Company other than Companies mentioned in the next succeeding section, deriving profits principally from the owner-

111 ship, sale or rental of real estate or from the manufacture, sale or use of tangible personal property, such proportion of its entire net income as the fair cash value of its real estate and tangible personal property, in this State, on the date of the close of the fiscal year of such Company in the income year is to be the fair cash value of its entire real estate and tangible personal property then owned by it, with no deduction on account of incumbrances thereon.

In case of a corporation deriving profits principally from the holding or sale of intangible property such proportion as its gross receipts in this State for the year ended on the date of the close of its fiscal year next preceding is to its gross receipts for such year within and without the State.

"Section 202. Railroads and public service corporations.—

"The basis of ascertaining the net income of every corporation engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the Standard Classification of Accounting of the Interstate Commerce Commission, shall be the 'net operating income' of such corporations as shown by their records kept in accordance with that Standard Classification of Accounts, when their business is wholly within this State and when their business is in part within and in part without this State, including in their gross 'operating revenues' within this State the equal mileage proportion within this State of their interstate business and deducting from their gross 'operating revenues' the proportionate average of operating expenses' or 'operating ratio', for their whole business, as shown by the Interstate Commerce Commission Standard Classification of Accounts. From the net operating income thus ascertained shall be deducted 'uncollectible revenue' and taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes, and the balance shall be deemed to be their net income taxable under this Act."

The foregoing section relating to the basis of ascertaining the net income of railroads was supplemented by Chapter 35 of the Public Laws of 1921, as follows:

"Sec. 1. That in determining the taxable income of a corporation engaged in the business of operating a railroad under section two hundred and two of the act to raise revenue, in the case of a railroad located entirely within this State, the net operating income shall be increased or decreased to the extent of any credit or debit balance received or paid, as the case may be, on account of car hire, and when any railroad is located partly within and partly without this State, then said net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid, as the case may be, on account of car hire."

112 Section 203 of the Income Tax Act of 1921, as amended by Chapter 35, Public Laws of 1921, is as follows:

"Section 203. Such tax shall first be levied, collected and paid in the year 1922, and with respect to the net income received during the calendar year 1921, and annually thereafter."

Section 3 of Chapter 34, Public Laws of 1921, provides:

"No tax on any property in the State shall be levied for any of the uses of the State Government. The taxes hereinafter levied in this act are for the expenses of the State Government, the appropriations to its educational, charitable and penal institutions, pensions for Confederate Soldiers and widows, the interest on the debt of the State, an equalizing fund for public schools, and other specific appropriations made by law, and shall be collected and paid into the general fund of the State Treasurer."

"Section 306. Deductions.—

"In computing net income there shall be allowed as deductions:

"1. All the ordinary and necessary expenses paid during the income year in carrying on any trade or business, including:

"(a) As to individuals, wages or employees for services actually rendered in producing such income.

"(b) As to partnerships, wages of employees and a reasonable allowance for co-partners or members of a firm, for services actually rendered in producing such income, the amount of such salary allowance to be included in the personal return of the co-partner receiving same.

"(c) As to corporations, wages of employees and salaries of officers, if reasonable in amount, for services actually rendered in producing such income.

"2. Rentals or other payments required to be made as a condition of the continued use or possession, for the purposes of the trade of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

"3. All interest paid during the income year on indebtedness except interest on obligations contracted for the purchase of non-taxable securities. Dividends on preferred stock shall not be deducted as interest.

"4. Taxes for the income year, except taxes on income and war profits, and excess profits taxes, inheritance taxes, and taxes assessed for local benefit of a kind tending to increase the value of the property assessed.

113 "5. Dividends from stock in any corporation the income of which shall have been assessed and the tax on such income paid by the corporation under the provisions of this

Act: Provided, that when only part of the income of any corporation shall have been assessed under this act, only a corresponding part of the dividends received therefrom shall be deducted.

"6. Losses sustained during the income year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit.

"7. Debts ascertained to be worthless and charged off within the income year, if the amount has previously been included in gross income in a return under this act.

"8. A reasonable allowance for the depreciation and obsolescence of property used in the trade or business; and, in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion: Provided, that in computing the deductions allowed under this paragraph, the basis shall be the cost (including in the case of mines, oil and gas wells, and other natural deposits, the cost of development, not otherwise determined) and in the case of property acquired prior to January 1, 1921, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of costs up to that date. The reasonable allowances under this paragraph shall be made under rules and regulations to be prescribed by the Tax Commission. In the case of leases the deductions allowed may be equitably apportioned between the lessor and lessee.

"9. In the case of taxpayers who keep regular books of account, upon an accrual basis and in accordance with standard accounting practice, reserves for bad debts and for contingent liabilities, under such rules and restrictions as the Tax Commission may impose. If the Tax Commission shall, at any time, deem the reserve excessive in amount, it may restore such excess to income, either in a subsequent year or as a part of the income of the income year and assess it accordingly.

"10. Contributions or gifts made within the taxable year to corporations or associations operated exclusively for religious, charitable, scientific or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inure to the benefit of any private stockholder or individual, to an amount not in excess of fifteen per centum of the taxpayer's net income as computed without the benefit of this subdivision.

"11. Resident individuals having an established business in another State, or investment in property in another State, may deduct the net income from such business or investment, if such business or investment is in a State that levies a tax upon such net income. The deductions authorized in this subsection shall in no case extend to any part of income or resident individuals from personal services or mortgages, stocks, bonds, securities and deposits.

114 "12. In the case of a non-resident individual, the deductions allowed in this section shall be allowed only if, and to

the extent that, they are connected with income arising from sources within the State; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the State shall be determined under rules and regulations prescribed by the State Tax Commission.

Complainant is engaged in operating an interstate railroad and keeps its accounts in accordance with the Standard Classification of Accounts prescribed by the Interstate Commerce Commission and is required to pay an income tax under the appropriate part of Section 202 of The Income Tax Act or suffer the penalties prescribed in said Act.

Complainant respectfully shows the Court that the said Act is void as to complainant for the following reasons:

(a) Article 5, Section 3 of the Constitution of North Carolina authorizes the levy of a tax upon net incomes, and the statutory method prescribed in Section 202 for complainant and like corporations in order to arrive at net income results in the tax being levied on a sum which is not in truth and in fact net income, but includes a part of complainant's operating revenue in this:

Section 202 provides that railway corporations in the class of complainant shall first arrive at gross operating revenue within the State of its interstate business, and from this gross revenue shall deduct the following items:

(1) Proportionate average of operating expenses, as shown by the Interstate Commerce Commission Standard Classification of Accounts.

(2) Uncollectible revenue.

(3) Taxes paid in North Carolina for the income year, other than taxes and war profits and excess profits taxes.

(4) An equal proportion of car hire.

Plaintiff alleges that defendants, unless restrained by order of this Court will, pursuant to the provisions of the Statutes in force in the State of North Carolina, levy upon and assess against it the income taxes for the year 1922 and certify such levy and assessment to the officers charged with the enforcement and collection thereof, amounting to a large sum in excess of \$3,000.00 to-wit, the sum of \$19,616.46, whereas plaintiff avers that if it is allowed the deductions to which it is entitled it would not have any taxable income because the sum of such deductions is greater than its gross income, and that unless said taxes are paid within the time fixed by the Statute, plaintiff will be subjected to heavy penalties and that the levy of such taxes will constitute a lien upon its property and thereby a cloud upon its title thereto, and that plaintiff will suffer other and irreparable damage, etc., all of which will appear by reference to the allegations set out in its bill herein. The plaintiff's bill seeking an injunction, restraining defendants in the discharge of the official duties imposed by the Statute is based

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upon the allegation that the sections of the Revenue Act of 1921, and especially upon those sections known as the "Income Tax Act" violate the Constitution of the State of North Carolina and of the United States for that among other reasons:

1st. The tax levied as directed by said Statute is not a tax on net incomes but is levied upon gross income, or real net operating income and hence is repugnant to the State Constitution and to the Commerce Clause of the Federal Constitution.

2nd. The classification made by Section 202 of the Act as to method of ascertainment of net income for plaintiff and other corporations within the designed class is arbitrary, without reasonable or practical basis and hence is repugnant to the Uniformity Clause, Art. 5, Sec. 3 of the State Constitution and the Equal Protection Clause of the Fourteenth Amendment to the Constitution of the United States.

That it is a violation of the State Constitution for the general property tax to be devoted to local purposes and the various exercise, privilege, franchise, license, and income taxes to be devoted to State purposes.

That the income tax is invalid because it is levied in addition to property and franchise taxes. That the method of ascertaining the taxable income of plaintiff fixed or prescribed by Sec. 202 of the Act violates the provisions of Art. 5, Sec. 3 of the State Constitution and of the Fourteenth Amendment to the Federal Constitution, for that such method is not applied to such railroads or other public service corporation which do not operate their properties but have income only from rentals paid *them* by other companies to whom they lease their entire properties to be operated by the lessees.

It is pertinent, in view of the questions presented by the bills and answers and the prayer for injunctive relief to note the provisions of Section 700-701 of the Income Tax Act as amended by the Act of 1921, creating the office known as Commissioner of Revenue, providing for the prescribing the procedure in applications for revision and appeal from assessments and levies of taxes against all persons or corporations having property in, or being liable for, tax in the State.

The Legislature at its Special Session of 1921, made further provisions for refunding any taxes of any kind which have been through clerical error or misinterpretation or otherwise, collected or paid into the State Treasury in excess of the amount legally due the State and directing the State Auditor to issue his warrant for the amount so illegally collected to the person entitled thereto, upon certificate of the head of the department through which said taxes were collected or his successor in the performance of the functions of that department, with the approval of the Attorney General and the Treasurer to pay the sum out of any funds in the treasury not otherwise appropriated.

Upon consideration of the bill and answer, Exhibits and evidence, it is

Adjudged and decreed that plaintiff is not entitled to have the

defendants or either of them enjoined and restrained from the performance of the duties imposed upon them by the Statutes of North Carolina, relating to the administration, assessing, levying and enforcement or collection of the income tax against plaintiff. That the bill be dismissed. That defendants recover their cost to be taxed by the Clerk.

This the 7th day of November, 1922.

At Wilson, N. C.

H. G. CONNOR,
U. S. District Judge.

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Notice of Appeal.

Filed Nov. 16, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 448.

ATLANTIC COAST LINE RAILROAD COMPANY, Plaintiff,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.

Notice of Appeal.

To the defendants in the above-entitled action and Honorable James S. Manning, Attorney General of North Carolina, and Frank Nash, Assistant Attorney General, Solicitors for defendants:

You will please take notice that, on Friday, November 17th, 1922, at 10:00 o'clock A. M., or as soon thereafter as counsel may be heard, the above named plaintiff will apply to his Honor, Henry G. Connor, District Judge, at the United States Court Room, Wilmington, N. C., for an order allowing plaintiff to appeal to the Supreme Court in the above cause, and granting a stay of proceedings until the appeal shall have been heard, passed upon and disposed of by the Supreme Court of the United States.

ATLANTIC COAST LINE RAILROAD
COMPANY,

By THOMAS W. DAVIS,
Solicitor.

Service accepted this 16th day of November:

JAMES S. MANNING,
*Attorney General of North Carolina
and Solicitor for Defendants.*

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Order Granting Thirty Day Stay.

Filed Nov. 18th, 1922.

In the District Court of the United States for the Eastern District of
North Carolina.

In Equity.

No. 448.

ATLANTIC COAST LINE RAILROAD COMPANY

vs.

A. D. WATTS, as Commissioner of Revenue of North Carolina, and
Others.

Income Tax Suit.

It is ordered that the defendants shall not proceed to enforce the collection of taxes involved in this litigation for the period of thirty days from the date of this order, to the end that complainant may take such action in the premises as it is advised to.

Dated at Wilmington, North Carolina this the 17th day of
November, 1922.

H. G. CONNOR,
U. S. Judge.

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Assignment of Errors.

Filed Nov. 27, 1922.

In the District Court of the United States for the Eastern District of
North Carolina.

In Equity.

No. 448.

ATLANTIC COAST LINE RAILROAD COMPANY, Complainant,

vs.

A. D. WATTS, Individually and as Commissioner of Revenue of
North Carolina, et al., Defendants.

Assignment of Errors.

Comes now the complainant in the above entitled cause, and in connection with his petition for appeal from the final decree made November 7, 1922 and filed November 13, 1922 by said Court, deny-

ing complainant's motion for an injunction and dismissing its bill of complaint, files the following assignment of errors:

The Court erred:

(1) In decreeing that an injunction be denied to complainant and in dismissing its bill.

(2) In holding that for the purpose of its application for an injunction complainant was not entitled under its pleadings and proof to have such injunction.

(3) In failing and refusing to hold that complainant is denied the equal protection of the law and deprived of its property without due process of law in violation of the Fourteenth Amendment to the Constitution of the United States by the taxation of its income under North Carolina Income Tax Act of 1921, in that said Income Tax Act arbitrarily and unreasonably allows certain deductions to other corporations not public service corporations which are denied to railroad companies and other public service corporations.

(4) In failing to hold that the North Carolina Income Tax Act of 1921, both by its direct provisions and as sought to be applied to complainant operates as a direct burden upon interstate commerce, contrary to Section 1, Article 8 of the Constitution of the United States relating to the regulation of interstate commerce, in that said Income Tax Act does not tax the true net income of railroad companies, but imposes a tax in part upon gross income of such companies which derived from interstate commerce.

(5) In failing to hold that said Income Tax Act of 1921, in its operation and attempted application to complainant denies complainant the equal protection of the law in violation of the Fourteenth Amendment to the Constitution of the United States, and unlawfully discriminates against complainant in that it in fact taxes in part the gross income of complainant and other railroad corporations and taxes such income on a wholly different basis from that of other corporations not public service corporations, without any reasonable basis or ground for such distinction and discrimination.

(6) In failing and refusing to hold that the income tax imposed by said Income Tax Act of 1921 is not arrived at by a uniform rule as required by Section 3, Article 5 of the Constitution of North Carolina, and that such lack of uniformity greatly discriminates against and operates to the detriment of complainant in violation of the Fourteenth Amendment to the Constitution of the United States relating to the equal protection of the law and taxation of property without due process of law.

(7) In failing to hold that the method of taxing complainant's taxable income as provided by Section 202 of said Income Tax Act of 1921 violates the Constitution of North Carolina and denies complainant the equal protection of the law in violation of the Fourteenth Amendment to the Constitution of the United States, in that it does

not apply to railroads and other public service corporations which derive their income from sources other than the operation for
121 their property, thereby resulting in unlawful and unjust discrimination against complainant and other railroad companies.

(8) In failing to hold that the system of taxation existing in North Carolina particularly with respect to interstate railroad corporations by which various taxes are pyramided one upon the other, thus taxing several times the same elements of property under various names such as ad valorem taxes on both tangible and intangible property and so called privilege taxes and income taxes, operates as a regulation of an undue burden upon interstate commerce in violation of Section 8, Article 1, Constitution of the United States.

(9) In failing to hold that said Income Tax Act of 1921 denies complainant the equal protection of the law and deprives it of its property without due process of law in violation of the Fourteenth Amendment to the Constitution of the United States, in that said Tax Act violates and departs from the scheme of taxation imposed by the Constitution of North Carolina by reason of the fact that, whereas the North Carolina Constitution requires that all property shall bear its just proportion of taxation and be taxed by uniform rule, large classes of property are by said laws exempted from taxation for said purposes and such loss of revenue to the State is recouped by the imposition of said Income Tax solely for said purposes; thereby imposing an additional burden upon and unlawfully discriminating against complainant.

(10) In failing to hold that said Income Tax Act of 1921 is unconstitutional and void and in violation of the Fourteenth Amendment to the United States Constitution as denying the equal protection of the law, in that it is retroactive to the extent that attempts to tax income for January, February and part of March, 1921, when said Act only became effective from its ratification on March 8, 1921.

122 (11) In failing to hold that said Income Tax Act of 1921, and particularly Section 600 thereof, was and is unconstitutional and void as denying to complainant due process of law in violation of the Fourteenth Amendment to the Constitution of the United States, for the reason that it imposed excessive and unreasonable penalties for a failure to pay taxes levied under said Act, namely, a penalty of double the amount of the tax; said excessive and unreasonable penalties being calculated to deter persons sought to be taxed, under the Act from testing the validity of same by judicial proceedings.

(12) That said Act does not provide a method for the taxation of income of the complainant as required by the Constitution of the State, or by uniform rule as compared with the income of other citizens, residents, persons or corporations doing business in the State of North Carolina and subject to an income tax, but is really an

attempt to enforce against Atlantic Coast Line Railroad Company, and other interstate carriers of the State of North Carolina and of the United States, engaged in interstate commerce, the payment of a tax on account of and for the reason that this complainant, and other companies similarly situated, are engaged in the business of conducting and carrying on interstate commerce by attempting through an unjust, unreasonable and illegal classification to require complainant and other railroad companies doing business in the State of North Carolina and engaged in interstate commerce, to pay an income tax upon more than their net income, while all other tax payers are taxed upon their net income.

(13) That the assessment for income tax made by the defendant A. D. Watts, as Commissioner of Revenue, against the complainant was not made upon the net income of this complainant, but was made upon what was termed its "net operating income," while all other individuals and corporations doing business in the State of

123 North Carolina and subject to income tax had their income tax assessed upon the basis of their net income, except corporations engaged in the business of operating steam or electric railroads, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the Standard Classification of Accounting of the Interstate Commerce Commission.

That the said assessment of the income tax made by the defendant A. D. Watts, as Commissioner of Revenue of North Carolina, was illegal and void, as being made upon a classification of complainant and other public service corporations engaged in interstate commerce and required to report to the Interstate Commerce Commission, and to keep their records in accordance with the orders of that Commission, and thereby imposed, or undertook to impose a tax upon the complainant by reason of the fact that it was engaged in interstate commerce, which tax is greater than would be imposed upon complainant if it were not engaged in such interstate commerce, and undertook to classify, for the purpose of an income tax and of ascertaining what constituted net income, taxpayers into two classes, to wit: Those engaged in interstate commerce in the operation of public service, as common carriers and all other taxpayers in the other class. That such classification was and is in violation and contravention of the Constitution of the United States, especially of the interstate commerce clause of Section 8, Article I; of Section 2, Article IV, and of Section 1, Article XIV, and is in violation and contravention of the Constitution of the State of North Carolina, especially Section 5, Article V thereof.

THOMAS W. DAVIS,
Solicitor for Complainant.

Y24

Stipulation of Counsel as to the Record.

Filed Dec. 5th, 1922.

In the District Court of the United States for the Eastern District
of North Carolina.

In Equity.

No. 448.

ATLANTIC COAST LINE RAILROAD COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.

Stipulation of Counsel as to Record.

It is stipulated and agreed by and between the parties to the above
entitled cause:

That the Clerk, in making up the transcript of record on this
appeal from the decree of the District Court shall include—

Bill of complaint and exhibits.

Application for interlocutory injunction.

Order on application for interlocutory injunction.

Notice of hearing on application for interlocutory injunction.

Answer.

Affidavit of J. H. Bridgers with exhibits.

Affidavit of Nathan O'Berry.

Affidavit of C. D. Bradham.

Affidavit of A. R. Turnbull.

Affidavit of J. C. Nelms.

Affidavit of J. C. Nelms.

Affidavit of J. C. Nelms.

Affidavit of F. C. Harding.

Affidavit of C. J. Joseph.

Affidavit of H. C. Prince without exhibits.

Affidavit of M. S. Hawkins.

Affidavit of E. H. Kemper.

Affidavit of O. S. Thompson.

Affidavit of A. J. Maxwell.

Affidavit of R. O. Self.

Testimony and exhibits.

Certificate of Corporation Commission as to certain lumber cor-
porations, and others licensed as common carriers and engaged in
intrastate commerce in North Carolina.

Notice of appeal.

Petition for appeal.

Assignments of error.

Order allowing appeal and granting supersedeas and stay.

Bond and Citation.

The exhibits attached to the affidavit of H. C. Prince are summarized in the affidavit of J. C. Nelms.

It is further stipulated that the Clerk may use in preparing the record on appeal printed copies of all such pleadings, documents, affidavits, etc., as may be furnished by the parties hereto.

THOS. W. DAVIS,

Solicitor for Complainant;

GEO. H. BROWN,

Of Counsel, Solicitor for Defendants;

Attorney General of N. C.

125 *Memorandum of Original Papers Certified Separately.*

Petition for Appeal filed Nov. 27, 1922.

Appeal allowed Nov. 27, 1922.

Appeal Bond dated Dec. 5, 1922; penalty, \$1,000.00; Obligors: Atlantic Coast Line Railroad Company and Fidelity & Deposit Company of Maryland; Conditioned for damages and costs.

Citation dated Nov. 27th, 1922; service accepted by George H. Brown, of Counsel for Defendants, Nov. 27, 1922.

126 *Order to Transmit Record.*

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

#448.

ATLANTIC COAST LINE RAILROAD COMPANY

vs.

A. D. WATTS, Commissioner of Revenue, et als.

And thereupon it is ordered by the Court here that a transcript of the record and proceedings in said suit be transmitted to the United States Supreme Court at Washington, D. C., and the same is transmitted accordingly.

S. A. ASHE,

Clerk United States District Court.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 448.

ATLANTIC COAST LINE RAILROAD COMPANY,

vs.

A. D. WATTS, Commissioner of Revenue, et als.

I, S. A. Ashe, Clerk, United States District Court, for the Eastern District of North Carolina, do hereby certify that the foregoing pages present a full, true and correct copy of the proceedings had and order entered in that certain suit in equity pending in said Court, wherein Atlantic Coast Line Railroad Company is complainant and A. D. Watt, Commissioner of Revenue of North Carolina, and others, are defendants.

In testimony whereof, I have hereunto set my hand and affixed the seal of the said District Court at the Courthouse in Raleigh, State of North Carolina, this 6th day of December, 1922.

[United States District Court, Eastern District of N. C. at Raleigh.]

S. A. ASHE,

Clerk United States District Court.

128 In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 448.

ATLANTIC COAST LINE RAILROAD COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.

Petition for Appeal.

To the Honorable Henry G. Connor, District Judge of the United States in and for the Eastern District of North Carolina;

The Atlantic Coast Line Railroad Company, Complainant herein, feeling itself aggrieved by the decree of the Court made and entered in this cause on November 7, 1922 and filed on November 13, 1922,

refusing and denying the injunction applied for in this cause to restrain and enjoin defendants as prayed for in complaint, does hereby appeal to the Supreme Court of the United States from said decree, refusing and denying said injunction applied for and dismissing its complaint, upon the grounds set forth in the Assignment of Errors filed herewith, and the Complainant prays that its appeal be allowed and that citation issue as provided by law and that a transcript of the record, proceedings, and documents upon which said decree is based duly authenticated, be sent to the Supreme Court of the United States, under the rules of such Court in such cases made and provided.

And Complainant further prays that the Court enter an order staying and superseding all proceedings by defendants or either of them against Complainant for the collection of taxes involved in this litigation, until the appeal herein prayed for shall have been passed upon and disposed of by the United States Supreme Court, and that a proper order *be* made touching the security to be required of Complainant to perfect its appeal and as a condition to said stay.

ATLANTIC COAST LINE RAILROAD
COMPANY.

By THOS. W. DAVIS,
Solicitor.

131 [Endorsed:] #448 Eq. District Court of the United States Eastern District of North Carolina, In Equity No. 448. Petition for Appeal. Atlantic Coast Line Railroad Company, Complainant, vs. A. D. Watts, Commissioner of Revenue of North Carolina, et al., Defendants. I certify that the within is entered and filed this day. Nov. 27, 1922. S. A. Ashe, Clerk, *Clerk.* Petition for Appeal.

132 & 133 In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 448.

ATLANTIC COAST LINE RAILROAD COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.

Order Allowing Appeal and Granting Supersedeas and Stay.

This cause coming on to be heard upon the application of complainant, Atlantic Coast Line Railroad Company, for an appeal to the Supreme Court of the United States, and for a supersedeas and order staying and restraining the collection of the income tax involved in this suit and alleged to be illegal in the complaint filed

herein, until the determination of the appeal in this cause now pending in the Supreme Court of the United States, and complainant being represented by Thomas W. Davis, its attorney, and the defendants by their attorneys, Frank Nash, Assistant Attorney General of North Carolina, and George H. Brown, the appeal prayed for is hereby granted, Appeal Bond in the sum of \$1,000.00 to be filed.

And the Court being of the opinion that the status quo between the parties should be preserved pending such determination of appeal by the complainant to the Supreme Court of the United States:

It is, therefore, decreed and adjudged that defendants, their agents, servants and employees and each of them be and are hereby restrained from collecting or attempting to collect from complainant the income tax which is the subject matter of this suit, pending the determination of the appeal by the complainant in this cause now pending in the United States Supreme Court.

It is further ordered and decreed that complainant do give bond, with good and sufficient surety, in the sum of Ten Thousand Dollars, to be approved by the Judge of the United States Court, or the Clerk of said Court, conditioned to pay to said defendants all of such income tax that may finally be determined in this cause to be legally due and payable by the complainant to the defendants.

Dated this 27th day of November, 1922.

H. G. CONNOR,

District Judge, Eastern District of North Carolina.

134 [Endorsed:] J. 448, Equity. Atlantic Coast Line Railroad Company vs. A. D. Watts, et als. Order Allowing Appeal & Granting Supersedeas & Stay under \$10,000 Bond. I certify that the within is entered and filed this day. Nov. 27, 1922. S. A. Ashe, Clerk.

135 In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 448.

ATLANTIC COAST LINE RAILROAD COMPANY, Complainant,
vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.
Defendants.

Appeal Bond.

Know all men by these presents: that we, Atlantic Coast Line Railroad Company, a corporation organized and existing under the laws of the State of Virginia, as principal, and Fidelity and Deposit Company of Maryland, as surety, are held and firmly bound unto the above named A. D. Watts, and the other defendants in the sum of One Thousand Dollars (\$1,000.00) to be paid to the said A. D. Watts

and other defendants, their successors and assigns, to which payment, well and truly to be made, we bind ourselves and our successors jointly and severally by these presents.

Sealed with our seals this 5th day of December, 1922.

Whereas, in a suit pending in the District Court of the United States for the Eastern District of North Carolina between Atlantic Coast Line Railroad Company, complainant, and A. W. Watts, et al., defendants, a final decree was rendered by the Court denying complainant the relief prayed for and dismissing the bill of complaint and the said Atlantic Coast Line Railroad Company having prayed and been allowed an appeal direct to the Supreme Court of the United States, and filed a copy thereof in the Clerk's Office of the said Court, and citation having issued directed to the A. D. Watts, et al., citing and admonishing them to be and appear in the Supreme Court of the United States within the time required by law.

Now the condition of the above obligation is such that if the said Atlantic Coast Line Railroad Company shall prosecute its said appeal to effect and answer all damages and costs if it fails to make its appeal good, then the above obligation shall be void, else to remain in full force and effect.

ATLANTIC COAST LINE RAILROAD
COMPANY,

By THOS. W. DAVIS,

Attorney in Fact.

[Seal of the Fidelity & Deposit Company of Maryland, Incorporated 1890.]

FIDELITY AND DEPOSIT COMPANY
OF MARYLAND,

By THEODORE S. JAMES,

Attorney in Fact.

Approved Dec. 6, 1922.

H. G. CONNOR,

Judge.

136 & 137 The President stated that the late General Solicitor P. A. Willeox, had been given authority by this Board to sign bonds on behalf of this Company required in legal proceedings in the States of North Carolina and South Carolina, and it is now desired to transfer this authority to his successor, Thomas W. Davis.

Whereupon, on motion duly made and seconded, it was unanimously

Resolved, that Thomas W. Davis, of Wilmington, North Carolina, be and is hereby authorized as Agent and Attorney in Fact of Atlantic Coast Line Railroad Company to sign, execute and deliver on behalf of said Company bonds and other instruments required in Court and other legal proceedings in the States of North Carolina and South Carolina.

I, R. D. Cronly, Assistant Secretary of the Atlantic Coast Line Railroad Company, do hereby certify that the above and foregoing is a correct excerpt from the minutes of meeting of the Board of Directors of the Atlantic Coast Line Railroad Company, duly called and held at 71 Broadway, in the City of New York, N. Y., on the twentieth day of April, 1922, at which a quorum was present and voted.

In testimony whereof, I have hereunto subscribed my name and affixed the seal of the said Atlantic Coast Line Railroad Company this twenty-second day of November, 1922.

[Seal of the Atlantic Coast Line Railroad Company.]

R. D. CRONLY,
Assistant Secretary.

138 [Endorsed:] #448. Eq. District Court of the United States, Eastern District of North Carolina. In Equity, No. 448. Atlantic Coast Line Railroad Company, Complainant, vs. A. D. Watts, Commissioner of Revenue of North Carolina, et al., Defendants. Appeal Bond. I certify that the within is entered and filed this day, Dec. 6, 1922. S. A. Ashe, Clerk.

139 & 140 In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 448.

ATLANTIC COAST LINE RAILROAD COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.

The United States of America to A. D. Watts, as Commissioner of Revenue of North Carolina, and James S. Manning, as Attorney General of North Carolina, Greeting:

Whereas, Atlantic Coast Line Railroad Company has lately appealed to the Supreme Court of the United States from a decree lately rendered in the District Court of the United States for the Eastern District of North Carolina, made in favor of you, the said Atlantic Coast Line Railroad Company having filed the security required by law, you are therefore hereby cited to appear before the said Supreme Court of the United States at the City of Washington on the 27th day of December next, to do and receive what may appertain to justice to be done in the premises.

Given under my hand at the City of Raleigh in the Fourth Circuit, this the 27th day of November, in the year of our Lord, One Thousand Nine Hundred and Twenty Two.

H. G. CONNOR,
*Judge of the District Court of the United
States for the Eastern District of North
Carolina.*

Service accepted.

GEO. H. BROWN,
Of Counsel for Defts.

Nov. 27, 1922.

I certify that the within is entered and filed this day.

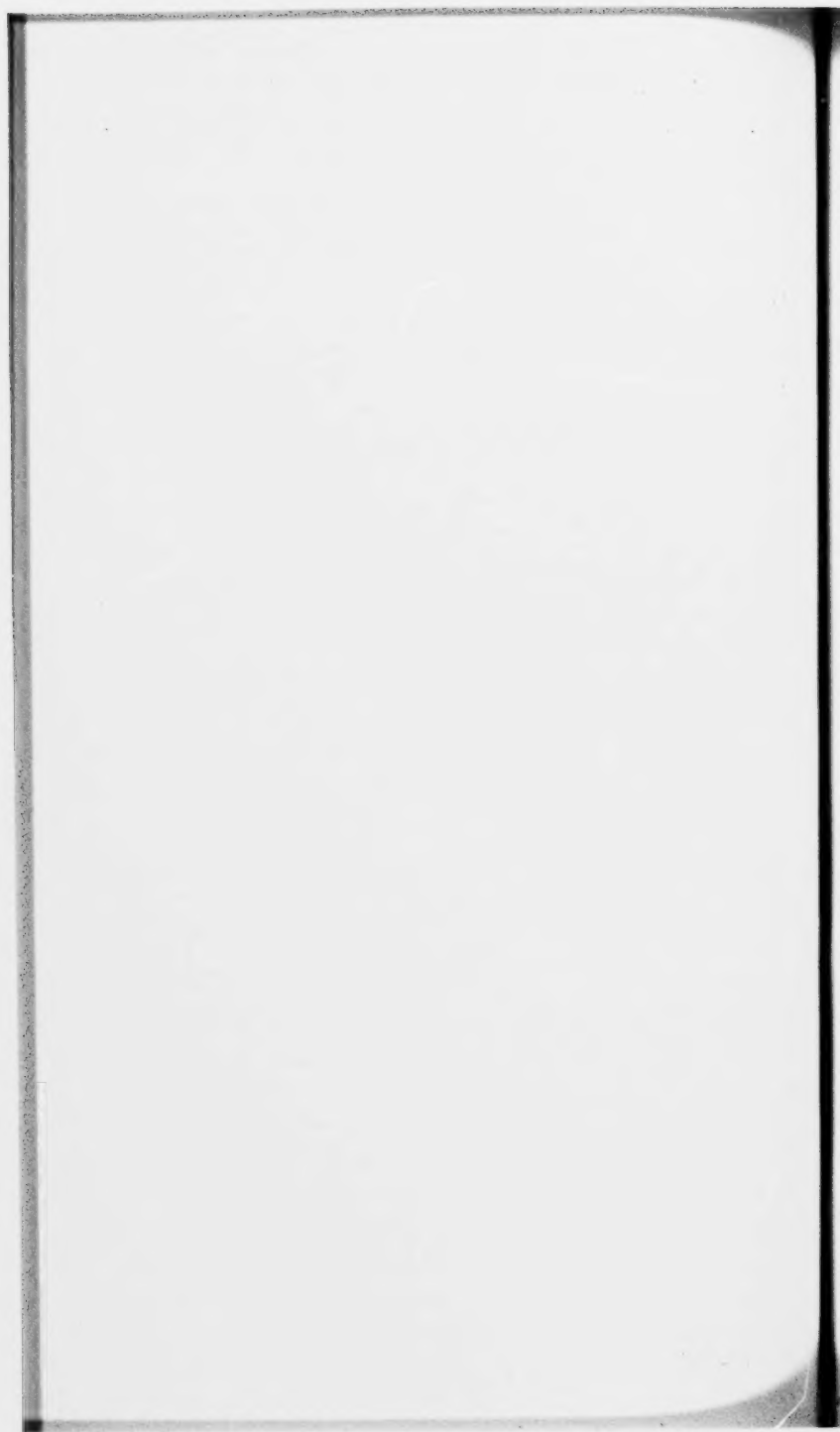
Nov. 27, 1922.

S. A. ASHE,
Clerk.

141 [Endorsed:] (J.) #448, Equity. Atlantic Cost Line Railroad Company vs. A. D. Watts et als. Citation and acceptance of service. I certify that the within is entered and filed this day. Nov. 27, 1922. S. A. Ashe, Clerk.

Endorsed on cover: File No. 29,274. E. North Carolina D. C. U. S. Term No. 724. Atlantic Coast Line Railroad Company, appellant, vs. A. D. Watts, Commissioner of Revenue of the State of North Carolina, et al. Filed December 9th, 1922. File No. 29,274.

(8245)



FILED

MAR 19 1923

WM. E. STANFORD

IN THE
Supreme Court of the United States

OCTOBER TERM, 1922.

No. 724.

ATLANTIC COAST LINE RAILROAD
COMPANY, Appellant,
vs.

A. D. WATTS, INDIVIDUALLY AND AS
COMMISSIONER OF REVENUE OF
NORTH CAROLINA, ET AL., Appellees.

**Motion for Leave to Substitute R. A. Doughton,
Commissioner of Revenue of North Carolina, for
A. D. Watts, Commissioner of Revenue of North
Carolina.**

THOS. W. DAVIS,
Counsel for Appellant.

March 19, 1923.



IN THE
Supreme Court of the United States

OCTOBER TERM, 1922.

No. 724.

ATLANTIC COAST LINE RAILROAD
COMPANY, Appellant,

vs.

A. D. WATTS, INDIVIDUALLY AND AS
COMMISSIONER OF REVENUE OF
NORTH CAROLINA, ET AL., Appellees.

Comes the Appellant, Atlantic Coast Line Railroad Company, and moves the Court to substitute R. A. Doughton as one of the Appellees in this cause in place of A. D. Watts, and, for grounds of said motion, respectfully shows:

A. D. Watts, individually and as Commissioner of Revenue of the State of North Carolina, together with James S. Manning, Attorney General of North Carolina, were the original defendants herein. A. D. Watts resigned the office of Com-

missioner of Revenue on January 29, 1923, and was on January 29, 1923, succeeded in office by R. A. Doughton, who now holds said office.

Wherefore, Appellant prays that R. A. Doughton be substituted for A. D. Watts.

THOS. W. DAVIS,
Attorney for Appellant.

The undersigned, James S. Manning, Attorney General of the State of North Carolina, and representing R. A. Doughton, the present Commissioner of Revenue of North Carolina, consents for said R. A. Doughton to the substitution hereinabove moved for.

JAMES S. MANNING,
Attorney for R. A. Doughton.

FILED
MAR 26 1923

WM. R. STANSBURY
CLERK

IN THE
Supreme Court of the United States

OCTOBER TERM, 1922

NO. 724

ATLANTIC COAST LINE RAILROAD COMPANY,
Appellant,

against

A. D. WATTS AND A. D. WATTS AS COMMISSIONER
OF REVENUE, ET AL;

Appellee.

IN EQUITY

APPEAL FROM THE DISTRICT COURT OF THE
UNITED STATES FOR THE EASTERN DISTRICT
OF NORTH CAROLINA.

BRIEF OF APPELLANT.

THOMAS W. DAVIS,
Solicitor for Appellant.
Wilmington, N. C.

GEORGE B. ELLIOT,
HARRY SKINNER,

Of Counsel.

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IN THE
Supreme Court of the United States

OCTOBER TERM, 1922

NO. 724

ATLANTIC COAST LINE RAILROAD COMPANY,
Appellant,
against

A. D. WATTS AND A. D. WATTS AS COMMISSIONER
OF REVENUE, ET AL.

Appellee.

IN EQUITY

APPEAL FROM THE DISTRICT COURT OF THE
UNITED STATES FOR THE EASTERN DISTRICT
OF NORTH CAROLINA.

BRIEF OF APPELLANT.

(Italics ours except where otherwise stated)

STATEMENT OF CASE

This suit was brought in the United States District Court for the Eastern District of North Carolina to enjoin the collection of an Income Tax of three per cent levied on plaintiff under what is known as the Income Tax Law of North Carolina, passed at the session of the Legislature of that State in

1921, upon the ground that the act violates the Constitution of the State of North Carolina and the Constitution of the United States.

We will hereafter more fully set out the contentions and the grounds upon which the injunction is asked and the act claimed to be unconstitutional.

The case was heard by the District Judge who rendered a decree adjudging that plaintiff was not entitled to an injunction and ordering the bill dismissed. The decree sets forth the contentions of the plaintiff, but does not set out any reasons for the dismissal of the bill.

CLAUSES OF CONSTITUTION AND STATUTES

Article 5, Section 3, of the Constitution of North Carolina, which authorizes the levy of an income tax is in the following words:

“Laws shall be passed taxing, by a uniform rule, all moneys, credits, investments in bonds, stocks, joint-stock companies, or otherwise; and, also, all real and personal property, according to its true value in money: Provided, notes, mortgages, and all other evidence of indebtedness given in good faith for the purchase price of a home, when said purchase price does not exceed three thousand dollars, and said notes, mortgages, and other evidence of indebtedness shall be made to run for not less than five nor more than twenty years, shall be exempt from taxation of every kind: Provided, that the interest carried by such notes and mortgages shall not exceed five and one-half per cent. The General Assembly may also tax trades, professions, franchises, and incomes: *Provided, the rate of tax on incomes shall not in any case exceed six per cent (6%), and there shall be allowed the following exemptions, to be deducted from the amount of annual incomes, to-wit: For a married man with a wife living with him, or to a widow or widower having minor child or children, natural or adopted, not less than \$2,000; to all other persons not less*

than \$1,000, and there may be allowed other deductions (not including living expenses) so that only net incomes are taxed.' " (Italics Amendment of 1920).

Purporting to act under the authority of this article of the Constitution, the Legislature of North Carolina, at its regular session, 1921, enacted a law providing for the levying, collecting and paying of an income tax on individuals and corporations, being Chapter 34 of the Public Laws of North Carolina of 1921, and being a part of what is known as the Revenue Act of 1921.

The pertinent provisions of this income tax law are as follows:

Section 100 provides that the income tax schedule shall be known and cited as the Income Tax Act of 1921, and we will so refer to it in this brief.

Section 101 provides:

"Sec. 101. Purpose. The general purpose of this act is to impose a tax, for the use of the State Government, upon the net income for the calendar year 1921, in excess of exemptions herein set out, collectible in the year 1922, and annually thereafter: (a) Of every citizen of the State. (b) Of every domestic corporation. (c) Of every foreign corporation and of every non-resident individual having a business or agency in this State, in proportion to the net income of such business or agency.

Except as otherwise provided in this act the purpose is to conform to the definitions of income in the revenue laws of the United States Government and regulations made under its authority, in so far as they apply.

The tax imposed upon the net income of corporations in this schedule is in the nature of a franchise tax for the privileges granted by the State to domestic corporations and to foreign corporations doing business in this State, and is in addition to the tax imposed under Schedule C of this act."

Section 102 provides:

"Sec. 102. Definitions. For the purpose of this act and unless otherwise required by the context:

1. The words "Tax Commission" mean the State Tax Commission.

2. The word "taxpayer" includes any individual, corporation or fiduciary subject to the tax imposed by this act.

3. The word "individual" means a natural person.

4. The word "fiduciary" means a guardian, trustee, executor, administrator, receiver, conservator, or any person, whether individual or corporation, acting in any fiduciary capacity for any person, estate or trust.

5. The word "person" includes individuals, fiduciaries, partnerships and corporations.

6. The word "corporation" includes joint-stock companies or associations and insurance companies.

7. The words "domestic corporation" mean any corporation organized under the laws of this State.

8. The words "foreign corporation" mean any corporation other than a domestic corporation.

9. The words "tax year" mean the calendar year in which the tax is payable.

10. The words "income year" mean the calendar year or the fiscal year, upon the basis of which the net income is computed under this act; if no fiscal year has been established they mean the calendar year.

11. The words "fiscal year" mean an income year, ending on the last day of any month other than December.

12. The word "paid" for the purposes of the deductions under this act means "paid or accrued" or "paid or incurred," and the words "paid or accrued," "paid or incurred," and "incurred," shall be construed according to the method of accounting upon the basis of which the net income is computed under this act. The word "received" for the purpose of the computation of the net

income under this act means "received or accrued," and the words "received or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under this act.

13. The word "resident" applies only to individuals, and includes for the purpose of determining liability to the tax imposed by this act, with reference to the income of any income year, any individual who shall be a resident of the State on the first day of the tax year. In the absence of other satisfactory indicia the residence of a person who has two or more places in which he occasionally dwells may be determined with reference to the place at which the individual lived the longest period of time during the income year.

14. The words "foreign country" mean any jurisdiction other than one embraced within the United States. The words "United States," when used in a geographical sense, include the States, the Territories of Alaska and Hawaii, the District of Columbia, and the possessions of the United States."

Section 201 provides:

"Sec. 201. Corporations. Every corporation organized under the laws of this State shall pay annually a franchise or excise tax, with respect to carrying on or doing business, equivalent to three per cent of the entire net income of such corporation, as herein defined, received by such corporation during the income year; and every foreign corporation doing business in this State shall pay annually a franchise or excise tax equivalent to three per cent of a proportion of its entire net income, to be determined according to the following rules:

This section was amended on December 19th, 1921, at the special session of the Legislature of North Carolina of 1921, being Chapter 102 of the Public Laws of North Carolina, Special Session 1921, as follows:

"Sec. 201. Corporations. Every corporation organized under the laws of this State shall pay annually an income tax equivalent to three per cent of the entire net income of such corporation, as herein defined, received by such corporation during year; and every foreign corporation doing business in this State shall pay annually an income tax equivalent to three per cent of a proportion of its entire net income, to be determined according to the following rules.

In case of a company other than companies mentioned in the next succeeding section, deriving profits principally from the ownership, sale or rental of real estate or from the manufacture, sale, or use of tangible personal property, such proportion of its entire net income as the fair cash value of its real estate and tangible personal property in this State on the date of the close of the fiscal year of such company in the income year is to the fair cash value of its entire real estate and tangible personal property then owned by it, with no deduction on account of incumbrances thereon.

In case of a corporation deriving profits principally from the holding or sale of intangible property, such proportion as its gross receipts in this State for the year ended on the date of the close of its fiscal year next preceding is to its gross receipts for such year within and without the State."

Section 202 provides:

"Sec. 202. Railroads and public service corporations. The basis of ascertaining the net income of every corporation engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, shall be the 'net operating income' of such corporations as shown by their records kept in accordance

with that standard classification of accounts, when their business is wholly within this State, and when their business is in part within and in part without the State their net income within this State shall be ascertained by taking their gross 'operating revenues' within this State, including in their gross 'operating revenues' within this State the equal mileage proportion within this State of their interstate business and deducting from their gross 'operating revenues' the proportionate average of 'operating expenses,' or 'operating ratio,' for their whole business, as shown by the Interstate Commerce Commission standard classification of accounts. From the net operating income thus ascertained shall be deducted 'uncollectible revenue,' and taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes, and the balance shall be deemed to be their net income taxable under this act."

Section 203 provides:

"Sec. 203. Such tax shall first be levied, collected, and paid in the year 1922, and with respect to the net income received during the calendar year 1921 or during any income year ending during the twelve months ending March 31, 1922."

Section 300 provides:

"Sec. 300. Net income defined. The words 'net income' mean the gross income of a taxpayer less the deductions allowed by this act."

Section 301 provides:

"Sec. 301. Gross income defined. 1. The words 'gross income' include gains, profits and income derived from salaries, wages or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, business, commerce or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property;

also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income of the income year in which received by the taxpayer, unless, under the methods of accounting permitted under this act, any such amounts are to be properly accounted for as of a different period.

2. The words 'gross income' do not include the following items, which shall be exempt from taxation under this act.

(a) The proceeds of life insurance policies and contracts paid upon the death of the insured to individual beneficiaries or to the estate of the insured.

(b) The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract.

(c) The value of property acquired by gift, bequest, devise or descent (but the income from such property shall be included in gross income).

(d) Interest upon the obligations of the United States or its possessions, or of the State of North Carolina.

(e) Salaries, wages, or other compensation received from the United States by officials or employees thereof, including persons in the military or naval forces of the United States.

(f) Any amounts received through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received, whether by suit or agreement, on account of such injuries or sickness."

Section 306 provides:

Sec. 306. Deductions. In computing net income there shall be allowed as deductions:

1. All the ordinary and necessary expenses paid during the income year in carrying on any trade or business including:

(a) As to individuals, wages of employees for services actually rendered in producing such income.

(b) As to partnerships, wages of employees and a reasonable allowance for copartners or members of a firm, for services actually rendered in producing such income, the amount of such salary allowance to be included in the personal return of the copartner receiving same.

(c) As to corporations, wages of employees and salaries of officers, if reasonable in amount, for services actually rendered in producing such income.

2. Rentals or other payments required to be made as a condition of the continued use or possession, for the purposes of the trade of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

3. All interest paid during the income year on indebtedness except interest on obligations contracted for the purchase of non-taxable securities. Dividends on preferred stock shall not be deducted as interest.

4. Taxes for the income year, except taxes on income and war profits, and excess profits taxes, inheritance taxes, and taxes assessed for local benefit of a kind tending to increase the value of the property assessed.

5. Dividends from stock in any corporation the income of which shall have been assessed and the tax on such income paid by the corporation under the provisions of this act: Provided, that when only part of the income of any corporation shall have been assessed under this act only a corresponding part of the dividends received therefrom shall be deducted.

6. Losses sustained during the income year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit.

7. Debts ascertained to be worthless and charged off within the income year, if the amount has previously been included in gross income in a return under this act.

8. A reasonable allowance for the depreciation and obsolescence of property used in the trade or business; and, in the case of mines, oil, and gas wells, other natural deposits, and timber, a reasonable allowance for depletion: Provided, that in computing the deductions allowed under this paragraph, the basis shall be the cost (including in the case of mines, oil and gas wells, and other natural deposits, the cost of development, not otherwise deducted), and in the case of property acquired prior to January 1, 1921, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date. The reasonable allowances under this paragraph shall be made under rules and regulations to be prescribed by the Tax Commission. In the case of leases the deductions allowed may be equitably apportioned between the lessor and lessee.

9. In the case of taxpayers who keep regular books of account, upon an accrual basis and in accordance with standard accounting practice, reserves for bad debts and for contingent liabilities, under such rules and restrictions as the Tax Commission may impose. If the Tax Commission shall at any time deem the reserve excessive in amount it may restore such excess to income, either in a subsequent year or as a part of the income of the income year and assess it accordingly.

10. Contributions or gifts made within the taxable year to corporations or associations operated exclusively for religious, charitable, scientific or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, to an amount not in excess of fifteen per centum of the taxpayer's net income as computed without the benefit of this subdivision.

11. Resident individuals having an established business in another State, or investment in property in another State, may deduct the net income from such business or investment, if such business or investment is in a State that levies a tax upon such net income. The deduction authorized in this subsection shall in no case extend to any part of income of resident individuals from personal services, or mortgages, stocks, bonds, securities and deposits.

12. In the case of a nonresident individual, the deductions allowed in this section shall be allowed only if, and to the extent that, they are connected with income arising from sources within the State; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the State shall be determined under rules and regulations prescribed by the State Tax Commission."

Section 3 of the Revenue Act of 1921, provides as follows:

"Sec. 3. State taxes. No tax on any property in the State shall be levied for any of the uses of the State Government. The taxes hereinafter levied in this act are for the expenses of the State Government, the appropriations to its educational, charitable, and penal institutions, pensions for Confederate soldiers and widows, the interest on the debt of the State, an equalizing fund for public schools, and other specific appropriations made by law, and shall be collected and paid into the general fund of the State Treasurer."

Chapter 96, Public Laws of North Carolina, Extra Session 1921, provides:

"Section 1. Whenever taxes of any kind are or have been through clerical error, or misinterpretation of the law, or otherwise, collected and paid into the State Treasury in excess of the amount legally due the State, the State Auditor shall issue his warrant for the amount so

illegally collected, to the person entitled thereto, upon certificate of the head of the department through which said taxes were collected or his successor in the performance of the functions of this department, with the approval of the Attorney General, and the Treasurer shall pay the same out of any funds in the treasury not otherwise appropriate: Provided, demand is made for the correction of such error or errors within two years from the time of such payment: Provided further, that claims which have arisen within the five years next preceding the ratification of this act shall be presented and made within two years from the ratification of this act.

“Sec. 2. This act shall be in force and effect from and after its ratification.

“Ratified this 19th day of December, 1921.”

ASSIGNMENTS OF ERROR

The formal assignments of error by plaintiff are found on pages 94 to 97 of the Record, but they may be summarized and abbreviated as follows:

1. The court erred in denying the injunction to plaintiff and dismissing the bill and in holding that for the purpose of its application for an injunction plaintiff was not entitled to it under its pleadings and proof. (Record, page 95).

2. The court erred in failing to hold that plaintiff is entitled to the equal protection of the law and deprived of its property without due process of law in violation of the Fourteenth Amendment to the Constitution of the United States by the taxation of its income under the North Carolina Income Tax Act of 1921, in that said Income Tax Act arbitrarily and unreasonably allows certain deductions to other corporations not public service corporations which are denied to railroads and other public service corporations, and in failing to hold that the said Income Tax Act discriminates against plaintiff in that it in fact taxes in part the gross income of plaintiff and other railroad corporations, and taxes such income on a

wholly different basis from that of other corporations not public service corporations, without any reasonable ground for such distinction and discrimination. (Section 3 and 5, Record page 95).

3. The court erred in failing to hold that the North Carolina Income Tax Act of 1921, both by its direct provisions and as sought to be applied to plaintiff operates as a direct burden upon interstate commerce, contrary to Section 1, Article 8, of the Constitution of the United States relating to the regulation of interstate commerce, in that said Income Tax Act does not tax the true net income of railroad corporations, but imposes a tax in part upon gross income derived from interstate commerce, and, further, for the reason, that the system of taxation existing in North Carolina with respect to interstate railroads by which the various taxes are pyramided one upon the other, thus taxing several times the same elements of property under various names such as ad valorem taxes on both tangible and intangible property and so-called privilege taxes and income taxes, which operate as a regulation of, and undue burden upon, interstate commerce in violation of Section 8, Article 1, of the Constitution of the United States. (Record, pages 95, 96).

4. The court erred in refusing to hold that the income tax imposed by said Income Tax Act is not arrived at by a uniform rule as required by Section 3, Article 5 of the Constitution of North Carolina, and that such lack of uniformity greatly discriminates against and operates to the detriment of plaintiff in violation of the Fourteenth Amendment to the Constitution of the United States, and in failing to hold that the method of taxing plaintiff's taxable income as provided by Section 202 of said Income Tax Act violates the Constitution of North Carolina and denied plaintiff the equal protection of the law in violation of the Fourteenth Amendment to the Constitution of the United States in that it does not apply to railroads and other public service corporations which derive their income from sources other than the operation of their

property, thereby resulting in unlawful and unjust discrimination against plaintiff and other railroad companies. (Record, pages 95, 96).

5. The court erred in failing to hold that said Income Tax Act denies plaintiff the equal protection of the law and deprives it of its property without due process of law in violation of the Fourteenth Amendment to the Constitution of the United States in that it violates and departs from the scheme of taxation imposed by the Constitution of North Carolina by reason of the fact that whereas the North Carolina Constitution requires that all property shall bear its just proportion of taxation and be taxed by uniform rule, large classes of property by said laws exempted from taxation for said purposes and such loss of revenue to the State is recouped by the imposition of said Income Tax solely for said purposes; thereby imposing an additional burden upon and unlawfully discriminating against plaintiff. (Record, page 95).

6. The court erred in failing to hold that said Income Tax Act, and particularly Section 600 thereof, was and is unconstitutional and void as denying to plaintiff due process of law in violation of the Fourteenth Amendment to the Constitution of the United States, for the reason that it imposed excessive and unreasonable penalties for the failure to pay taxes levied under said Act, namely, a penalty of double the amount of the tax; said excessive and unreasonable penalties being calculated to deter persons sought to be taxed, under the Act from testing the validity of same by judicial proceedings.

7. The court erred in failing to hold that said Act does not provide a method for the taxation of income of the complainant as required by the Constitution of the State, or by uniform rule as compared with the income of other citizens, residents, persons or corporations doing business in the State of North Carolina and subject to an income tax, but is really an attempt to enforce against Atlantic Coast Line Railroad Company, and other interstate carriers of the State of North Carolina and of the United States, engaged

in interstate commerce, the payment of a tax on account of and for the reason that this complainant, and other companies similarly situated, are engaged in the business of conducting and carrying on interstate commerce by attempting through an unjust, unreasonable and illegal classification to require complainant and other railroad companies doing business in the State of North Carolina and engaged in interstate commerce, to pay an income tax on more than their net income, while all other tax payers are taxed upon their net income.

8. The court erred in failing to hold that assessment for income tax made by the defendant A. D. Watts, as Commissioner of Revenue, against the complainant was not made upon the net income of this complainant, but was made upon what was termed its "net operating income," while all other individuals and corporations doing business in the State of North Carolina and subject income tax had their income tax assessed upon the basis of their net income, except corporations engaged in the business of operating steam or electric railroads, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the Standard Classification of Accounting of the Interstate Commerce Commission.

That the said assessment of the income tax made by the defendant A. D. Watts, as Commissioner of Revenue of North Carolina, was illegal and void as being made upon a classification of complainant and other public service corporations engaged in interstate commerce and required to report to the Interstate Commerce Commission, and to keep their records in accordance with the orders of that Commission, and thereby imposed, or undertook to impose a tax upon the complainant by reason of the fact that it was engaged in interstate commerce, which tax is greater than would be imposed upon complainant if it were not engaged in such interstate commerce, and undertook to classify, for the purpose of an income tax and of ascertaining what constituted net income, taxpayers into two classes, to-wit: Those engaged in

interstate commerce in the operation of public service, as common carriers and all other taxpayers in the other class. That such classification was and is in violation and contravention of the Constitution of the United States, especially of the interstate commerce clause of Section 8, Article I; of Section 2, Article IV, and of Section 1, Article XIV, and is in violation and contravention of the Constitution of the State of North Carolina, especially Section 5, Article V thereof.

ARGUMENT

I.

JURISDICTION

The Federal Court has jurisdiction of this case.

(1) Upon the ground of diversity of citizenship, plaintiff being a citizen and resident of the State of Virginia, and defendants being citizens and residents of the State of North Carolina. See paragraphs 1 and 2 of Bill, Record, pages 2, 3).

That plaintiff is a citizen and resident of the State of Virginia, see the following cases:

Lee v. Atlantic Coast Line Railroad Company, 150 Federal, 775.

Atlantic Coast Line Railroad Company v. Dunning, (C. C. A 4th Circuit), 166 Federal, 850.

(2) The amount in controversy exceeds three thousand dollars. (Record, page 3).

(3) This court has jurisdiction regardless of citizenship. Section 24 of the Judicial Code.

(4) It is alleged in the bill that the taxes and assessments are in violation of the Fourteenth Amendment to the Constitution of the United States and the Commerce Clause of the Constitution of the United States, as well as in violation of the Constitution of North Carolina. (Paragraphs 3, 12, 13, 15, 16, 17, 18, 19, 20, 21, 22 of the Bill, Record, pages 3, 6, 9, 10, 11 and 12).

Section 504, Chapter 34, Public Laws of North Carolina, 1921, being the Revenue Act, provides:

"If any tax imposed by this act or any portion of such tax be not paid within sixty days after the same becomes due, the Tax Commission shall issue an order under its hand and official seal directed to the sheriff of any county of the State, commanding him to levy upon and sell the real and personal property of the taxpayer, found within his county, for the payment of the amount thereof, with the added penalties, interest, and the cost of executing the same and return to the Tax Commissioner the money collected by virtue thereof by a time to be therein specified, not less than sixty days from the date of the order. The said sheriff shall thereupon proceed upon the same in all respects, with like effect, and in the same manner prescribed by law in respect to the executions issued against property upon judgments of a court of record, and shall be entitled to the same fees for his service in executing the order, to be collected in the same manner. If an order be returned not satisfied in full, the Tax Commission shall have the same remedies to enforce the claim for taxes against the taxpayer as if the State had recovered judgment against the taxpayer for the amount of the tax."

This, therefore, casts a cloud upon the plaintiff's title to this property. Therefore, this court has jurisdiction to hear and determine this cause on all the grounds above set forth.

Wallace v. Hines, 253 U. S., 66,
 Green v. L. & N. Railroad, 244 U. S., 499,
 Atlantic & P. Tel. Co. v. Philadelphia, 190 U. S., 160,
 L. & N. Railroad v. Green, 244 U. S., 522,
 L. & N. Railroad v. Baswell, 290 Federal, 380.

When jurisdiction is properly attached it extends to the whole case and all issues involved, whether of Federal or

non-Federal character,

side upon all the questions and the Court has authority to de-

Louisville Trust tions involved.

Louisville & N. E. Company v. Stone, 107 Federal, 305,

Railroad v. Taylor, 86 Federal, 168.

Complainant Has

The Consolidated States No Adequate Remedy at Law.

7979 (see appendix), statutes of North Carolina, 1919, Section granted by any Court provide that an injunction shall not of taxes nor to restrain or judge to restrain the collection payment of taxes, except the sale of any property for the non- be levied or assessed for such tax or the part thereof enjoined or be illegal and invalid for an illegal or unauthorized purpose

In construing this aid, or the assessment illegal or invalid. Carolina, in Sherrod v. statute, the Supreme Court of North the opinion being by J. Dawson, 154 N. C. 525, at page 528,

Mr. Justice Brown says:—

“An injunction taxes and to restrain will lie to restrain the collection of traint, for three restrain the sale of property under dis- any part thereof reasons, to-wit: (1). If the taxes or thORIZED purpose. be assessed for an illegal or unau- invalid. (2). If the tax itself be illegal or (3). If the assessment of the tax be illegal or invalid. Revised Sections, 821 and 2855. Purnell v. Page, 133 N. C. 125. (Italics ours.)

“In the case of Lumber Company v. Smith, 146 N. C. 199, which was an action brought to collect taxes on solvent credits, Justice Connor, writing the opinion of the Court, for an undivided bench, held that an injunction is the proper remedy as against delinquent taxes illegally sought to be collected. Upon the same point see also *Armstrong v. Stedman*, 130 N. C. 217. *Insurance Company v. Stedman*, 130 N. C. 221.

“In this case the injunctive relief sought is not merely ancillary to the principal relief demanded in the action but itself a main relief, for assuredly as to one or the other counties, the tax is illegal and invalid.

"In the case of *Hyatt v. DeHart*, 140 N. C. 270, this Court held that it is the general rule that the Court will not dissolve an injunction where the main relief demanded in the action is injunctive.

"In *Purnell v. Page*, 133 N. C., 129, the present Chief Justice spoke for the Court in these words 'As to the other point, whether the plaintiff can maintain an injunction against the sale of his property under an illegal tax, or must pay the tax under protest and sue to recover it back, it is equally well settled that he can pursue either remedy.'

"*Range Company v. Carver*, 118 N. C. 331, *Armstrong v. Stedman*, 130 N. C. 217, and *Brinkley v. Smith*, 130 N. C. 224, hold that under the language of the statute injunctive relief may be invoked by a taxpayer when the tax is invalid or illegal."

It appears from the decision, therefore, of Judge Brown that the Supreme Court has construed this statute to mean that a taxpayer under the laws of North Carolina is given his choice of either an injunction to restrain the collection of an illegal tax, or pay the same under protest and sue to recover it back.

Submission to the injunction of this action, by an Act entitled, "An Act to Refund Taxes Illegally Collected and Paid into the State Treasury," Chapter 96 Public Laws, N. C., Extra Session 1921, page 122, ratified the 19th day of December, 1921, it was provided as follows:

"Section 1. Whenever taxes of any kind are or have been through clerical error, or misinterpretation of the law, or otherwise, collected and paid into the State Treasury in excess of the amount legally due the State, the State Auditor shall issue his warrant for the amount so illegally collected, to the person entitled thereto, upon certificate of the head of the department through which said taxes were collected or his successor in the performance of the functions of that department, with

the approval of the Attorney-General, and the Treasurer shall pay the same out of any funds in the treasury not otherwise appropriated: Provided, demand is made for correction of such error or errors within two years from the time of such payment: Provided further, that claims which have arisen within the five years next preceding the ratification of this act shall be presented and made within two years from the ratification of this act."

It is contended by the appellees that the appellant is, by the provisions of this Act afforded an adequate remedy at law for the payment of the taxes involved in this action.

The Act does not require the payment back, except upon the certificate of the head of the department through which the taxes were collected "with the approval of the Attorney-General." It may or may not be possible to secure the certificate of the head of the Department or the approval of the Attorney-General. The State has not consented to be sued and therefore no remedy at law is provided by the Statute.

The facts alleged in the bill as to the inadequacy of the plaintiff's remedy at law entitle it to the equity jurisdiction of the Federal Courts is clearly shown by the following decisions:

- Raymond v. Traction Co., 207 U. S., page 20;
- Cummings v. Merchants Ntl. Bank, 101 U. S. 153;
- Taylor v. Louisville & Nashville R. Co., decision by present Chief Justice Taft, 88 Fed. 350;
- Smith v. Ames, 169 U. S. 466;
- Greene v. L. & N. R. Co., 244 U. S. 499;
- L. & N. R. Co. v. Green, 244 U. S. 522;
- Borden's Condensed Milk Co. v. Baker, 177 Fed. 906;
- Wallace v. Hines, 253 U. S. 66;
- Atlantic & Pacific Tel. Co. v. Philadelphia, 190 U. S. 160;
- L. & N. R. Co. v. Boswell, 209 Federal, 380.

II

The income tax is invalid because it is not levied upon net income but is levied upon operating income of the plaintiff, which is gross income and which violates Article 5, Section 3 of the Constitution of North Carolina.

Article 5, Section 3 of the Constitution makes it mandatory upon the State to levy an ad valorem tax for State purposes and permits the Legislature to tax trades, professions, franchises and income, Provided the rate does not exceed six per cent (6%), and Provided the exemptions therein shown are allowed. This article after providing these exemptions, concludes in the following language "And there may be allowed other deductions (not including living expenses) so that only net incomes are taxed."

Complainant contends, and justly so we think, that this section of the Constitution limits the power of the Legislature to the enactment of laws which will tax net income only. The words "income" and "net income" have a definite and well understood meaning, and this every day meaning must be construed by this Court to be the one which the people intended should be used in the interpretation of this article of the Constitution at the time of the adoption of the amendment in 1920.

Had the people of the State of North Carolina, when this article was amended, intended to permit the Legislature to levy a tax upon gross income they would have said so in plain and definite terms. We say that the plain intent of the Constitution therefore is that only net income shall be taxed. Net income does not mean gross income, with such exceptions as the Legislature or Commissioner of Revenue shall see fit to make. It means what it says, that is, that it shall be net income, and not gross income. The Constitution must be construed according to its true meaning. It cannot be construed to be a thing which, in truth and in fact, it is not, and was never intended to be.

In the interpretation of a Constitution or Statute levying

taxes, it is an established rule not to extend the provisions by implication beyond the clear import of the language used or to enlarge the operation so as to embrace matters not specifically pointed out.

Gould v. Gould, 245 U. S., 151;

American Net & Twine Co. v Worthington, 141 U. S., 468;

Benziger v. United States, 192 U. S., 38;

In *Eisner v. Macomber*, 252 U. S., 189, this Court had against the government in favor of the citizen. *Idem*.

in *Eisner v. Macomber*, 252 U. S., 189, this Court had before it the construction of the income tax levied by Congress and therefore, of course, the construction and interpretation of the Sixteenth Amendment was necessary to be considered.

The Court says, page 206:

“A proper regard for its genesis, as well as its very clear language, requires also that this Amendment shall not be extended by loose construction, so to repeal or modify, except as applied to income those provisions of the Constitution that require an apportionment according to population for the direct taxes upon the property, real and personal. This limitation still has no appropriate and important function, *and is not to be overridden by Congress or disregarded by the Courts.* (Italics ours).

“In order, therefore, that the clause cited from Article 1 of the Constitution may have proper force and effect, save only as modified by the Amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not ‘income,’ as the term is there used; and to apply the distinction as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it may adopt conclude the matter, since it cannot by any legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised.

"The fundamental relation of 'capital' to 'income' has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time. For the present purpose we require only a clear definition of the term 'income' as used in common speech, in order to determine its meaning in the Amendment; and, having formed also a correct judgment as to the nature of a stock dividend, we shall find it easy to decide the matter at issue."

The language used in a statute or constitution which has a settled and well known meaning sanctioned by judicial decision, is presumed to be used in that sense by the legislature or constitutional body.

Latimer v. United States, 223 U. S., 501;

Kepner v. United States, 135 U. S., 100;

Abbottsford, 98 U. S., 440.

The word "income" has been defined by the Court in *Stratton's Independence v Howbart*, 231 U. S., 399, 415, as follows:

"Income may be defined as the gain derived from capital, from labor, or from both combined."

Eisner v. Macomber, 252 U. S., 189, 207.

Miles v. Safe Deposit & Trust Co., decided May 29, 1922.

The word is defined in 26 Ruling Case Law, 149, as follows:

"The word income appears to have been used in the reported cases as meaning gross receipts, net earnings, gains or profits, depending on the context. In constitutional and statutory provisions in regard to taxation however, income appears to be uniformly construed as meaning net income, as opposed to gross receipts, which are also in some cases a measure of taxation. Income

means the balance of gain over loss and where there is no such balance of gain there is no income which is capable of being assessed. *The gross returns which an owner receives from his property do not denote his income, which means what he has for himself, what he can spend after satisfying all just outgoings in respect to the property which yield the return.*" (Italics ours).

There remains, therefore, to be considered, only the proper meaning the words "net income," as used in the constitution, and not as defined by the legislature.

The word "net" means free from charges or deductions obtained after deducting all expenses.

The words "net to us" in a telegram sent by plaintiff to defendant, offering to sell butter for 17c. "net to us" means that the price is to be 17c. free from all charges and deductions.

Floral Creamery v. Dillon (Conn.), 75 Atlantic, 82.

In *Fleet v. Hertz*, (Ill.), 66 N. E., 858, 861, the Court holds that where the furs were sold "net," this would mean that the seller was required to defray the cost of the delivery.

The Century Dictionary and Encyclopedia gives the following definition of the word "net":

"Clear of anything extraneous; with all deductions (such as are charges, expenses, discounts, commissions, taxes, etc.) made: as net profits, or net earnings; net proceeds; net weight." "Net profits, what remains, as the clear gain of any business adventure, after deducting the capital investment in the business, the expense incurred, in its management and the losses sustained by its operation."

Webster defines as follows:

"Free from extraneous substance; clear of, or free from, all charges, deductions, etc.; (a) remaining after deduction of all charges, outlay, loss, etc.; as net profit;

net proceeds; net income. (b) Clear of or excluding all tare, tret or the like; as net weight."

In *St. John v Erie Railway Company*, 89 U. S., 136, the Court considered the definition of the words "net earnings." The Court says:

"The preferred dividends were to be paid out of 'the net earnings of the road.' The lexical definition of net is 'clear of all charges and deductions.' Webster. 'That which remains after the deduction of all charges or outlay, as net profit.' Worcester. The popular acceptance of the term is the same."

In *Scott v. Harley*, 25 N. E., 826, 828, the Indiana Court defined "net" to be clear of all tare, tret, and other deductions taking the definition as used in the dictionaries.

The Illinois Court, in *Gibbs v. People's National Bank*, 64 N. E., 1060, defines the word "net" as:

"Clear of anything extraneous, with all deductions, such as charges, expenses, discounts, commissions, taxes, etc., made; free from expense" again taking the same definition as used in the dictionaries.

To the same effect is the definition given by the Texas Court in *Turnley v. Michael*, 15 S. W., 912.

The Maine Court, in *Andrews v. Boyd*, 5 Me., 199, defines the term "net" as a term used among merchants to designate the quantity, amount or volume of an article or commodity after all tare and charges are deducted.

In *Bromley v. Elliott* (N. H.), 75 Am. Dec., 182, the Court says:

"The term 'net income' cannot be understood to mean gross profits."

Applying the principle of construction laid down in *Eisner v. McCumber*, *supra*, to the Constitution of North Carolina, it is clear that the words "so that net incomes only are taxed" must be construed to mean that only that portion of the income

shall be taxed after deducting all charges, expenses, discounts, commissions, taxes, interest, etc. In other words, that the term "net" must be taken to mean, what it has always been defined to mean, "what remains of a business venture after the deductions of all charges and expenses incurred in the management." These words in the Constitution are a limitation upon the power of the Legislature to tax incomes and cannot be over-ridden, or disregarded, either by the Legislature or by the Courts, and the collection therefore, of any amount, due under the terms of this statute as income, should be enjoined as illegal and in contravention of the Constitution.

The General Assembly of 1921, in recognition of the limitation which the Constitution has imposed upon it in passing an income tax law, declared the general purpose of the act to be to impose a tax upon the net income. Section 101 provide, "The general purpose of this act is to impose a tax for the use of State Government upon the net income, etc."

Under the provisions of the Act of Congress the Interstate Commerce Commission has adopted a uniform system of accounting known as the "Standard Classification of Accounts," a copy of which has been filed in this case. This classification of accounts is made in order to arrive at what is gross income, operating revenue and net income. In order to arrive at the true net income, therefore, of a railroad corporation, doing an interstate business, and keeping its accounts in accordance with this classification of accounts, the following deductions must be made:

- Joint Facility Rents;
- Rent for Leased Roads;
- Miscellaneous Tax Accruals;
- Separately Operated Properties—Loss;
- Interest on Funded Debt;
- Interest on Unfunded Debt;
- Amortization of Discount on Funded Debt;
- Maintenance of Investment Organization;
- Income Transferred to other Companies;

Miscellaneous Income Charges,

and possibly one or two other deductions.

The North Carolina statute provides for a tax to be paid upon operating revenue after deducting uncollectible revenue and taxes paid within the State for the income year, and car hire. The statute therefore does not fix a tax on net income but a tax upon what it calls "net railway operating income." There is no such term as "net railway operating income" in the standard classification of accounts of the Interstate Commerce Commission, but if the term "net railway operating income" is to be construed as that income defined as such in Section 1 of the Federal Control Act, in Section 15-A of the Interstate Commerce Act and Section 209 of the Transportation Act of 1920, then this complainant is entitled in addition to the deductions allowed by the North Carolina Statute, the following deductions:

- Locomotive hire;
- Work Equipment hire;
- Floating Equipment hire;
- Joint Facility Rents

all of which are set forth in the said classification of accounts.

The result of this statute, and of the interpretation of the statute by the Commissioner of Revenue as set forth in the forms which he requires interstate railroad corporations to fill out and send for the purpose of assessing taxes against them, is that the machinery provided by the North Carolina Statute for the ascertainment of net income does not in truth and in fact produce net income, although Section 101 of the statute declares it to be the purpose of the act to tax "net income." Notwithstanding this declared purpose of the act the method outlined under the law for arriving at net income does not produce net income but produces a figure which is gross income with three deductions.

Manifestly therefore, accepting the definitions of net income set forth above, such deductions must be permitted before it can be determined what the railroad company has

left over for itself and what it can spend after satisfying all of its just expenses in respect of the property which yields revenue. Revenue and net income are distinct and separate accounts. Revenue cannot be converted into net income until items of expenses which have produced the revenue have been deducted.

Writers on Economics all distinguish between capital and income and the definitions given by them are pertinent in respect to what is a proper definition of the words "net income."

In *The Federal Income Tax*, Edited by Robert Murray Haig, Columbia University Press, 1921, 27, is found the following:

"Income is the money value of the net accretion of economic power between two points of time. This definition cannot be written into a statute in literal form because of the technical disadvantages in determining income as so defined, but so long as taxable income differs appreciably from this definition there will be anomalies and injustices in income taxation and other steps marking a closer approximation of this definition will result in the elimination of irregular and eccentric results."

In a book entitled "The American Law Relating to Income and Principal," the writer in his introduction says:

"The necessity of distinguishing carefully between income and principal is imposed chiefly upon trustees, and with them it is a matter of great importance; but the same necessity is imposed upon life tenants who have the possession and control of the property, and the same general principles apply to both."

This same writer further says:

"In determining whether dividends on shares of stock in corporations or joint stock companies are income or are wholly or part corpus the same general principles of preserving the corpus intact and not using it up as income applies in other investments. If dividends are not

paid out of earnings, but are really divisions of the capital of the corporation or company, they constitute part of the principal of the trust, and should be treated as income in the absence of a contrary intention of the creator of the trust."

An income tax is not a tax upon capital. It is a tax solely upon gains and profits.

Seligman in his work on income tax, revised edition, 19 says:

"Income is that which comes in to an individual above all necessary expenses of acquisition, and which is available for his own consumption. Income as contrasted with capital denotes that amount of wealth which flows in during a definite period and which is at the disposal of the owner for purposes of consumption so that in consuming it his capital remains unimpaired.

"Income is of course to be distinguished from mere receipts or gross revenues, it is more than that which simply comes in from any economic activity. *By income is always meant net income, as opposed to gross income.*" (Italics ours) "In other words, from the receipts in any enterprise we must in the first place, deduct the expenses of the enterprise—that is, the outlay incurred in securing the gross product. But secondly, income as a personal category differs from net profits. If a debt has been contracted in order to secure the product of a given piece of property or of a given enterprise, the interest on the debt must be deducted. Finally, in the outlays or expenses which have been incurred to secure the product, there must also be included a compensation for wear and tear of plant; just as the investor in securities computes his actual income by deducting an amortization quota from the annual proceeds. *Income, therefore, always means net income.* (Italics ours).

The Public Service Commission of New York, page 213, Reports of 1908, defines net income as follows:

"10. Gross Income, Income Deductions, and Net Corporate Income defined.

Revenues, diminished by expenses, taxes and uncollectible bills give an amount called GROSS INCOME, which is applicable to corporate and leased properties. Gross Income is subject to several compulsory deductions, mostly contractual, like rent, interest, etc., and the remainder after these are made is called NET CORPORATE INCOME, which being subject only to the discretion of the corporation is most conveniently carried directly to the concrete surplus. The accounts covering the compulsory deductions from gross income, as above defined, are called the INCOME DEDUCTION accounts."

The Interstate Commerce Commission in its order of May 19, 1914, defines Income Accounts, as follows:

"Income accounts are those designed to show, as nearly as practicable, for each fiscal period, the total amount of money that a carrier becomes entitled to receive for services rendered the returns accrued upon investments, the accrued costs paid or payable for the service rendered by it, the loss sustained by it, the amount accrued for taxes, for the use of moneys and for the use of properties of others, and the appropriations made from income during the period. The net balance of income (or loss) shall be carried to Profit and Loss."

In the same order it prescribes a form of Income Statement for common carriers, in which the outstanding items are:

- I. Operating Income.
 - II. Non-operating Income.
- (The total of these two is designated as "Gross Income.")
- II. Deductions from Gross Income.

Among the deductions are:

- "Rent for leased roads."
- "Miscellaneous Rent."

"Interest on Funded Debt."

"Interest on Unfunded Debt, etc."

The total of these deductions from Gross Income leaves a balance, termed by the Commission "Net Income."

Railroads are financed by the issuance of stock, and also by the sale of bonds. It is simply a question of how the money can be secured to the best advantage. It is true that the proceeds from the sale of bonds are used in the purchase of capital assets, described in the Commission's classification under the head of—"Investment in Road Equipment." It is equally true that the interest on such bonds is not charged to Capital Account, but is included as a deduction from Gross Income, as part of the expense of conducting the business. It is just as truly a deduction from Gross Income as are rents, and other expenses incidental to the conduct of the business.

The Commission, in its rules, specifically prohibits a road in operation from charging to its Capital Account the interest on bonds or other funded indebtedness.

The defendants in the argument below relied greatly upon the affidavit of Mr. Maxwell, a member of the North Carolina State Tax Commission (Record pages 54, 57, 58 and 59) His testimony for the State in reference to the rent for leased lines, etc., was as follows:

"With reference to the matters of rentals paid for the lines leased and operated by railroads, the committees considered the well known facts that these leases are usually for the long terms and with numerous collateral obligations which make them amount practically to purchases of the lessor road's property by the lessee, and that, this being true, the consideration paid for such long leases of property used fully as if the property of the lessee in its business is really not an operating expense but is by clear analogy and in practical effect a capital expense. If these expenses were allowed as deductions to the plaintiffs, the results would be that they would have no income subject to tax until they had earned enough to provide, not only for all business and operating

expenses, but also for all capital expenses and had paid all interest on their bonds; in other words, it would amount to nothing more than a tax on the savings of railroads, which would render the tax utterly incommensurate with that imposed on individuals and other ordinary corporations."

Mr. Maxwell is, therefore mistaken in his statement that interest thus deducted would be equivalent to providing the capital expense out of Operating Income. Mr. Maxwell is also, incorrect in his assumption in the matter of rentals paid for leased lines. Such rentals are usually based upon the value of the property and no matter what the length of the lease may be, a railroad, in paying such rental, acquires no equity in the property, and is under obligation to return the property at the end of the lease in as good condition as when received. The rental paid for such lease lines is, therefore, a proper deduction from Gross Income to the same extent and in the same manner as is the rental paid by an individual for the house in which he lives, and in which he acquires no equity whatever by the payment of such rental.

Mr. Maxwell further states that under the railroads' convention they would provide for all capital expenses before arriving at Net Income. As a matter of fact, the Accounting Classification of the Interstate Commerce Commission do not permit the charge to Income of any items representing capital expenditure. It has been in effect for many years, and is

This accounting has been in effect for many years, and is well understood by governmental regulating bodies as well as by all officers employed in the operation of railroads.

III.

because it allows Intrastate Railroads The Act is invalid it does Interstate Railroads and dis- greater deductions than roads doing business both within and eliminates against railroads thus violates the Constitution of the without the State and Constitution of North Carolina. United States and the

(a)

There are five different classes of corporations attempted to be classified by the income tax act of 1921, under Section 201 to 204, inclusive, and 300 to 306, inclusive as follows:

(1) Corporations engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business or other form of public service *when such companies are required to keep records according to the standard classification of accounting of the Interstate Commerce Commission and whose business is in part within and in part without the state* are required to pay a tax equal to 3 per cent of their gross operating revenues within the state, including therein the equal mileage proportion within this state of their interstate business and deducting therefrom the proportionate average of the operating expenses or operating ratio for their whole business as shown by the Interstate Commerce Commission standard classification of accounts, and from the amount thus ascertained is deducted uncollectible revenue and taxes paid in the state other than income tax and war profits and excess profit taxes and there is also deducted any debit balance paid on account of car hire.

(2) Corporations engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service *when such companies are required to keep records according to the standard classification of accounting of the Interstate Commerce Commission and whose business is wholly within the state* are required to pay a tax equal to 3 per cent of their "net operating income" as shown by their records kept in accordance with the standard classification of accounts with the deductions above set forth.

(3) Corporations engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service, *when such companies are not required to keep records according to the standard classification of accounting of the Interstate Com-*

merce Commission are required to pay a tax of 3 per cent on net income similar to that imposed upon all other corporations by section 201 of the Income Tax Act and such corporations are allowed deductions from their gross income set out in section 306 of the said act, which deductions are not allowed corporations referred to in (1) and (2) above.

(4) Corporations which own a steam or electric railroad, express service, telephone or telegraph business, or other form of public service and which are not engaged in the operation thereof, but have an income from other sources, such as leases, rentals, etc., are allowed the same deductions as other corporations and pay the tax only on net income.

(5) Every corporation organized under the laws of North Carolina and every foreign corporation doing business in the state, except the corporations referred to in paragraphs (1) and (2) are required to pay a tax equivalent to 3 per cent of their net income and in arriving at net income such corporations are allowed the deductions set out in section 306 of the **Income Tax Act**.

The provisions of section 202 are restricted to corporations engaged in interstate commerce because by the terms of the interstate commerce act only such corporations are required to keep their accounts according to the standard classification of the accounting of the Interstate Commerce Commission. (Act to Regulate Commerce Feb. 4th, 1887, c. 104, sec. 20, 24 Stat. 386 as amended; Barnes' Federal Code, 1921 Supplement, Sec. 7916.)

The affidavits of M. S. Hawkins (Record Page 35), and H. E. Kemper (Record page 39), filed in behalf of the plaintiff herein, show that railroads like the Atlantic & North Carolina, which is leased to the Norfolk Southern, the North Carolina Railroad, which is leased to the Southern Railway, the Durham and South Carolina leased to the Norfolk Southern Railway, and other like corporations in the State of North Carolina, are not taxed on their income "because they are

not engaged in the business of operating a steam or electric railroad, etc.”

These same leased railroads however produce revenue for their stockholders and lessors. The State of North Carolina is a stockholder in some of them, but there are individual stockholders also.

This produces a plain and arbitrary discrimination against the plaintiff. A corporation owning a railroad which it leases to another railroad, although it receives an honest income from that and other sources, is not liable for an income tax imposed upon corporations “engaged in business.”

McCoach v. Minehill and S. H. R. Co., 228 U. S., 295, 303, 304.

The Court in that case says:

“From the facts stated above it is entirely clear that and 1910 engaged at all in the business of maintaining the Minehill Company was not, during the years of 1909 or operating a railroad, which was the prime object of incorporation. This business, by the lease of 1896 it had turned over to the Reading Company . . . And it is the Reading Company, and not the Minehill Company, that is doing business as a railroad company upon the lines covered by the lease.”

The classification under this statute is arbitrary and unreasonable, and is invalid under the case of *Royster Guano Co. v. Virginia*, 253 U. S., 412. In that case the court held that the act of Virginia of 1916, in so far as it imposed on a domestic corporation doing business both within and without the State, a tax with respect to its income derived from sources outside the State denied such a corporation the equal protection of the laws in violation of the Fourteenth Amendment in view of another Act of Virginia, which exempted domestic corporations doing no part of their business within the state from any tax on their income. The Court also held

that classification for the purpose of legislation must be reasonable and not arbitrary, and must rest upon some ground of difference having a fair and substantial relation to the object of the legislature so that all persons similarly circumstanced shall be treated alike.

In *Southern Railway Company v. Green*, 216 U. S., 400, the Court says:

“While reasonable classification is permitted without doing violence to the equal protection of the laws, such classification must be based upon some real and substantial distinction, bearing a reasonable and just relation to the things in respect to which such classification is imposed; the classification cannot be arbitrarily made without any substantial basis. Arbitrary selection, it has been said, cannot be justified by calling it classification. *Gulf C. & F. R. Co. v. Ellis*, 165 U. S., 150; *Cotting v. Kansas City Stock Yards Co.*, (*Cotting v. Godard*), 183 U. S., 79; *Conolly v. Union v. Sewer Pipe Co.*, 184 U. S., 540.

“It is averred in the complaint and must be taken as admitted, that there are other corporations of a domestic character in Alabama, carrying on the railroad business in precisely the same way as the plaintiff. It would be a fanciful distinction to say that there is any real difference in the burden imposed because the one is taxed for the privilege of a foreign corporation to do business in the state, and the other for the right to be a corporation. The fact is that both corporations do the same business in character and kind, and under the statute in question a foreign corporation may be taxed many thousands of dollars for the privilege of doing, within the state, exactly the same business as the domestic corporation is permitted to do by a tax upon its privilege, amounting to only a few hundred dollars.

“We hold, therefore, that to tax the foreign corporation for carrying on business under the circumstances

shown, by a different and much more onerous rule than is used in taxing domestic corporations for the same privilege, is a denial of the equal protection of the laws, and the plaintiff being in position to invoke the protection of the Fourteenth Amendment that such attempted taxation under a statute of the state does violence to the Federal Constitution."

In *G. C. & S. F. R. Co., v. Ellis*, 165 U. S., 150, which is probably the leading case upon discrimination by arbitrary classification, the Court says:

"It is apparent that the mere fact of classification is not sufficient to relieve a statute from the reach of the equality clause of the Fourteenth Amendment, and that in all cases it must appear not only that a classification has been made, but also that it is one based upon some reasonable ground, some difference which bears a proper relation to the attempted classification, and is not a mere arbitrary selection."

Bell's Gap R. Co. v. Pennsylvania, 134 U. S., 232.

Magoun v. Bank, 170 U. S. 283.

Keeny v. New York, 222 U. S., 525.

In *Southern Railway v. Greene*, 216 U. S., 400, the Court says:

"Arbitrary selection cannot be justified by calling it classification."

In the case of *Cotting v. Godard*, 183 U. S., 79, the Court said:

"But while recognizing to the full extent the impossibility of an imposition of duties and obligations mathematically equal upon all, and also recognizing the right of classification of industries and corporations, we must nevertheless, always remember that the equal protection of the laws is guaranteed, and that such equal protection is denied when upon one of two parties engaged in the

same kind of business and under the same conditions burdens are cast which are not cast upon the other."

It is very apparent that burdens are cast upon plaintiff in this case which are not cast upon intrastate railroads in North Carolina which do not keep their accounts in accordance with the standard classification of accounting fixed by the Interstate Commerce Commission.

In the case of *Truax v. Corrigan*, 257 U. S. 312, this Court had before it the application of the equal protection clause of the Constitution, and specifically passed upon the question of arbitrary selection and classification. This opinion was by Mr. Chief Justice Taft, from which we quote the following language:

"In *Hayes v. Missouri*, 120 U. S., 68, 30 L. ed., 578, 7 Sup. Ct. Rep., 350, the Court, speaking through the same justice, said the Fourteenth Amendment 'does not prohibit legislation which is limited either in the objects to which it is directed or by the territory within which it is to operate. It merely requires that all persons subjected to such legislation shall be treated alike, under like circumstances and conditions, both in the privileges conferred and in the liabilities imposed.' Thus, the guaranty was intended to secure equality of protection not only for all, but against all similarly situated. Indeed, protection is not protection unless it does so. Immunity granted to a class, however limited, having the effect to deprive another class, however limited, of a personal or property right, is just as clearly a denial of equal protection of the laws to the latter class as if the immunity were in favor of, or the deprivation of right permitted worked against, a larger class."

(b)

This discrimination violates the uniformity clause of the Constitution of North Carolina and under the following decisions of the Supreme Court of North Carolina is invalid:

State v. Williams, 158 N. C., 610.

State v. Moore, 113 N. C., 698.

Pruitt v. Commissioners, 99 N. C., 709.

Worth v. Railroad, 89 N. C., 291.

Redmond v. Town of Tarboro (N. C.), 10 S. E., 845.

In the last case the Court said, after quoting from numerous cases:

"These cases decide that, when the taxing power is exercised for a public purpose, *the Constitution, and not the Legislature*, declare what property shall be taxed, and by a uniform rule, and *ad valorem*."

In Mercantile Company v. Mount Olive, 161 N. C., 125, 76 S. E., 691, it is said:

"In Lacy v. Packing Co., 134 N. C., 572 (47 S. E., 53), the above authority and others were cited, the court thus summing up the law: 'It is settled that a license tax is uniform when it is equal upon all persons belonging to the described class upon which it is imposed.' It is pointed out that the constitutional provision requiring uniformity applies only to property, but, as to license taxes, it quotes with approval the following from State v. Stephenson, 109 N. C., 734 (14 S. E., 387), 26 Am. St., 595: 'It is within the legislative power to define the different classes and to fix the license tax required of each class. All he can demand is that he shall not be taxed at a different rate from others in the same occupation, as classified by legislative enactment. This is stated as a universal rule. 1 Cooley on Taxation (3d Ed.), 260.'"

In the case of Worth v. Railroad, 89 N. C., 291, the tax law under consideration provided for the taxation of three classes of railroads, and the taxes imposed upon one were not imposed upon the other two. The three classes of railroads are described in the opinion at page 294, as follows:

"1. If the road is, by virtue of the contract contained in its charter, exempt from taxation upon its property or

shares, a tax is levied upon the incorporation equal in amount to one per centum upon its gross receipts.

2. If it be exempt from liability to taxation upon its real estate held 'for right of way, for station places and workshop locations,' following the language of the exemption contained in the charter of the North Carolina railroad company, as amended in the act of February 14th, 1855, but is liable to a tax upon its franchise and personal estate, it is subjected to a tax of one per centum upon the gross receipts.

3. If the property of the road be exempt, and it be not liable to the preceding tax, it was before subjected to a tax of one per cent upon the cash value of the shares, and by the act of 1881 instead, to what is termed a privilege tax of twenty-five dollars per annum for each mile of its track through its entire extent."

In holding that this method of the taxation of railroads violates the Constitution of North Carolina, Chief Justice Smith says :

"The first enumerated tax is not general in its application to railroads and canals, but is special and confined to such only as fall within the descriptive words of the statute, and the same is strictly true as to the others. The obvious result of this legislation is to impose burdens on exempted roads, which are not imposed upon those unexempted, and pro tanto to counteract the effect of the discriminating privileges and immunities that would otherwise subsist between them.

If the same general burdens were put upon all alike, whatever might be the subject matter of the taxation, the favored roads would continue to possess and enjoy the privileges conferred in their charter, and not found in the charters of the others. Indirectly, then, the legislation tends to withdraw the immunities secured by their charters, and constituting a contract between the State and themselves, or lessen their value, so that all may proxi-

mately, at least, stand upon the same footing, as if none such had been conferred.

We should be reluctant to hold, if there were no question of constitutional right involved, that this method of levying taxes was sanctioned by our own constitution, and consistent with the equality and uniformity which it contemplates.

The 'uniform rule' to be observed in the exercise of the taxing power seems to be so far applicable to the taxes imposed on 'trades, professions, franchises and incomes,' as to require that no discriminating tax be imposed upon persons pursuing the same vocation, while varying amounts may be assessed upon vocations or employments of different kinds.

'Although it is not expressly provided that the tax on trades, etc., shall be uniform,' in the words of Rodman, J., delivering the opinion of *Gatlin v. Tarboro*, 78 N. C., 139, 'yet a tax not uniform, as properly understood, would be so inconsistent with natural justice, and with the intent which is apparent in the section of the constitution above cited (Art. 5, Sec. 3) that it may be admitted that the collection of such a tax would be restrained as unconstitutional.' This uniformity prescribed in the Constitution of Illinois, as declared by Mr. Justice Miller, extends 'to the class upon which the law shall operate; that is inn-keepers may be taxed by one, ferries by another, railroads by another (rule); provided, that the rule as to inn-keepers be uniform as to all inn-keepers; the rule as to ferries be uniform as to all ferries, and the rule as to railroad companies be uniform as to all railroad companies.' *Railroad Tax Cases*, 92 U. S., 575. The governing principle is not that the same specific tax shall be paid by each, as a form of capitation tax, but that, whether levied upon and measured by the amount of gross or net earnings or other standard, as upon real or personal estate, there shall be no discrimination made among the

individuals of a class, based upon privileges and immunities secured to one under contract and not to another. The essential element in all systems of taxation is equality in imposing burdens upon the property of the taxpayers, so that each one, possessing the same species of property, shall pay the same proportionate tax as every other levied upon that property, and in this State such tax is required to be ad valorem."

Under these authorities therefore we say that the Act is invalid because it is discriminating against this complainant and in favor of other corporations, and because the tax is not uniform.

In *State v. Willams*, supra, the Court held that in paying a tax the different subjects thereof must be reasonable, though not arbitrarily classified and a different rule of taxation prescribed for each class provided the rule is uniform in its application to the class for which it is made, and the result must be to prevent discrimination among individuals or subjects of any one class, based upon special privileges, immunities or exemptions allowed to one and not allowed to the other.

It is apparent from the authorities cited that the Income Tax Act is invalid, in that while all of the railroad companies doing business in the State are entitled to be placed in one class with reference to taxation, there is a clear discrimination against interstate railroads, in favor of intrastate railroads because intrastate railroads are allowed different and greater deductions than allowed to interstate railroads which imposes upon the latter a different and higher rate of taxation than upon the former.

The affidavit of J. H. Bridgers (Record, pages 33, 34), shows that he is President of the Henderson Water Company, which is a public service corporation, and that this corporation does not keep its accounts in accordance with standard classification of accounting of the Interstate Commerce Commission, and that under his accounting his corporation was not liable to income tax in North Carolina for the year 1921, but if his

accounts had been kept in accordance with the classification of accounting of the Interstate Commerce Commission he would have had to pay in accordance with the standard and this arises only from the fact that the Interstate Commerce Commission keeps its accounts in accordance with the standard classification of the Interstate Commerce Commission. Therefore, it does not have to pay the taxes which keep their accounts in accordance with that classification.

IV.

THE INCOME TAX ACT IS VOID BECAUSE IT IS A TAX AND BURDEN UPON INTERSTATE COMMERCE AND VIOLATES THE COMMERCE CLAUSE OF THE CONSTITUTION OF THE UNITED STATES.

The State of North Carolina taxes the entire property of the plaintiff, real, personal and intangible, as a going concern at full value, and this value is found by the Commissioner of Revenue, and was formerly found by the State Tax Commission. It is found by the assessment of the entire property of the railroad under Section 64 of the Machinery Act of 1921, Public Laws, 1921, page 265, which reads as follows:

"(a) At such dates as real estate is required to be assessed for taxation, the said commission shall first determine the value of the tangible property of each division or branch of such railroad of rolling stock and all other physical or tangible property. This value shall be determined by a due consideration of the actual cost of replacing the property, with a just allowance for depreciation on rolling stock, and also of other conditions, to be considered as in the case of private property.

"(b) They shall then assess the value of the franchise.

which shall be determined by due consideration of the gross earnings as compared with the operating expenses, and particularly by consideration of the value placed upon the whole property by the public (the value of the physical property being deducted), as evidenced by the market value of all capital stock, certificates of indebtedness, bonds, or any other securities, the value of which is based upon the earning capacity of the property.

“(c) The aggregate value of the physical or tangible property and the franchise as thus determined, shall be the true value of the property for the purpose of an ad valorem taxation, and shall be apportioned in the same proportion that the length of such road in each county bears to the entire length of such division or branch thereof; and the State Tax Commission shall certify, on or before the first day of September, to the chairman of the county commissioners and the mayor of each city or incorporated town the amount apportioned to his county, city, or town; all taxes due the State from any railroad company shall be paid by the treasurer of each company directly to the State Treasurer within thirty days after the first day of July of each year; and upon failure to pay the State Treasurer as aforesaid, he shall institute an action to enforce the same in the County of Wake or any other county in which such railroad is located, adding thereto twenty-five per centum of the tax. The board of county commissioners of each county through which said railroad passes shall assess against the same only the tax imposed for county, township, or other taxing district purposes, the same as levied on other property in such county, township, or special taxing districts.”

Upon the assessment made under this Act the railroad pays what is known as ad valorem taxes to the counties, cities and towns, and special taxing districts. Then by Section 82 (61½) of the Revenue Act of 1921, being Chapter 34, Public Laws, 1921, there is assessed upon this entire valuation of the rail-

road a tax of one-tenth of one per cent for State purposes. This section is as follows:

Sec. 82 ($6\frac{1}{2}$). Railroads. Every railroad company doing business in this State shall annually on or before the thirtieth day of July make and return to the State Tax Commission, in such form and upon such blanks as shall be furnished by the State Tax Commission, and giving such information as the State Tax Commission shall require, for the purpose of carrying out the provisions of this section, and upon which report the State Tax Commission shall ascertain and certify to the State Auditor the value upon which the amount of taxes which shall be paid by any such railroad company as a franchise or privilege tax shall be calculated. The basis upon which such calculation shall be made by the State Tax Commission and the extent to which every such railroad company is exercising its franchise in this State shall be found to be the value of the property, tangible and intangible, of each such railroad company in the State assessed for the year in which such report is made for ad valorem taxes. The franchise tax of each such railroad company for the privilege of exercising its franchise in this State shall be one-tenth of one per cent (0.1%) of the value so ascertained by the State Tax Commission, and such tax shall be due and payable on or before the fifteenth day of October in each year. If any such company shall fail to make the report provided for, it shall be the duty of the State Tax Commission to make an approximation from the reports and records on file in that department of the amount of taxes due under this section, and certify same to the State Auditor and Treasurer for collection. No county, city or town shall be allowed to collect any taxes under this section.

This Court in an opinion handed down on the 2d day January, 1923, decided that the ad valorem and so-called State franchise tax acts, quoted above, and the assessments levied

plaintiff, and the other railroads in North
 thereon, against this pl
 Carolina, were valid. y, et al. v. Watts, United States Su-
 Southern Railw Advance Opinions, February 1, 1923,
 preme Court
 page 199. that by these two acts the plaintiff

Thus it will be seen railroad property at full value taken
 is already taxed on it and this income tax is nothing more
 as a going concern, in the gross receipts disguised by the
 than an effort to reac
 name of an income tax. It is shown it is apparent that this tax is

From the facts already shown it is apparent that this tax is
 not a tax upon net income but is a tax upon gross income. Be-
 not a tax upon net income which in itself is derived partly
 ing a tax upon gross income and partly from interstate com-
 from intrastate commerce because it attempts to tax such part of
 merce, the act is void of the complainant which it derived
 the operating revenue, as is represented by the propor-
 from interstate commerce of the complainant's entire system, ex-
 tion of the mileage of the complainant's entire system, ex-
 mileage of railroad of the complainant's entire system, ex-
 tending into many states. The amount of the tax therefore is
 largely dependent upon the volume of interstate commerce
 done by this complainant, and therefore amounts to a direct
 commerce.

burden upon interstate commerce almost identically the same as the tax
 The tax in this case is almost identically the same as the tax
 condemned by this Court in Galveston, Harrisburg, etc.,
 R. R. v. Texas, 210 U. S. 217. That case involved the validity
 of a Texas statute imposing a tax upon railroads and other
 corporations owning or controlling any line of railroad within
 that State, equal to one-tenth of one per cent (and repealing
 the existing tax law), on gross passenger earnings of rail-
 roads. Section 1 of the statute imposes—

“an annual tax for the year 1905 and for each calendar
 year thereafter equal to one per centum of its gross re-
 cepts, if such line of railroad lies wholly within the
 State,”

and Section 2 requires a report under oath of—

“the gross receipts of such line of railroad from every source whatever, for the year ending on the 30th day of June last preceding, and immediate payment of the tax, calculated on the gross receipts so reported.”

The lines of railroad of the plaintiff lay wholly within the State of Texas but they connected with other lines and a part, and in some instances the larger part, of the gross receipts was derived from the carriage of passengers and freight in interstate commerce. In the opinion of the Court Mr. Justice Holmes referred to the prior cases, including the case of *Maine v. Grand Trunk*, *Philadelphia & Southern Mail Steamship Company v. Pennsylvania*, *Adams Express Company v. Ohio*, *Pullman Company v. Pennsylvania*, and the other cases of like nature involving the construction of taxes upon railroads and public service corporations, and in commenting upon the case of *Maine v. Grand Trunk Railroad*, he says:

“In *Maine v. Grand Trunk R. R. Co.*, supra, ‘an annual excise tax for the privilege of exercising its franchise’ was levied upon every one operating a railroad in the State, fixed by percentages, varying up to a certain limit, upon the average gross receipts per mile multiplied by the number of miles within the State, when the road extended outside. This seems at first sight like a reaction from the *Philadelphia & Southern Mail Steamship Company* case. But it may not have been. The estimated gross receipts per mile may be said to have been made a measure of the value of the property per mile. That the effort of the State was to reach that value, and not to fasten on the receipts from transportation as such, was shown by the fact that the scheme of the statute was to establish a system. The buildings of the railroad and its land and fixtures outside of its right of way were to be taxed locally, as other property was taxed, and this excise with the local tax were to be in lien of all taxes. *The language*

shows that the local tax was not expected to include the additional value gained by the property being part of a going concern. That idea came in later. The excise was an attempt to reach that additional value. The two taxes together fairly may be called a commutation tax."

Further he says:

"By whatever name the exaction may be called, if it amounts to no more than the ordinary tax upon the property or a just equivalent therefor, ascertained by reference thereto, it is not open to attack as inconsistent with the constitution . . . The question is whether this is such a tax. It appears sufficiently, perhaps from what has been said, that we are to look for a practical rather than a logical or philosophical distinction. The State must be allowed to tax the property, and to tax it at its actual value as a going concern. On the other hand, the State cannot tax the interstate business. The two necessities hardly admit of an absolutely logical reconciliation. Yet the distinction is not without sense. When a legislature is trying simply to value property, it is less likely to attempt or to effect injurious regulation than when it is aiming directly at the receipts from interstate commerce. *A practical line can be drawn by taking the whole scheme of taxation into account. That must be done by this Court as best it can. Neither the State Courts nor legislature, by giving a tax a particular name or by the use of some form of words can take away our duty to consider its nature and effect.* If it bears upon commerce among the states so directly as to amount to a regulation in a relatively immediate way, it will not be saved by name or form. *Stockard v. Morgan*, 185 U. S., 27, 37, 46 L. Ed., 785, 794, 22 Sup. Ct. Reps., 576; *Asbel v. Kansas*, 209 U. S., 251, 254, 256, ante, 778, 780, 781, 23 Sup. Ct. Rep., 485.

"We are of the opinion that the statute levying this tax does amount to an attempt to regulate commerce

among the states. The distinction between a tax 'equal to' one per cent of gross receipts, and a tax of one per cent of the same, seems to us nothing except where the former phrase is the index of an actual attempt to reach the property and to let the interstate traffic and the receipts from it alone. We find no such attempt or any thing to qualify the plain inference from the statute, taken by itself. *On the contrary we rather infer from the judgment of the State Court and from the judgment on behalf of the State that another tax on the property of the railroad is upon a valuation of that property taken as a going concern. This is merely an effort to reach the gross receipts not even disguised by the name of an occupation tax and in no way helped by the words 'equal to.'*"

The following propositions are laid down in this case:

1. The State may tax the property of an interstate corporation and tax it at its actual value as a going concern.
 2. But it cannot tax the interstate business.
 3. That in determining whether the tax is void the whole scheme of taxation must be taken into account.
 4. That neither the State Court nor the legislature, by giving a tax a particular name or by use of some form of words, can take away the duty of the Court to consider its nature and effect.
 5. That if it bears upon commerce between the states so directly as to amount to a regulation in a relatively immediate way it will not be saved by name or form.
 6. That the Court, in deciding the case of *Maine v. Grand Trunk Railway*, decided, in upholding the statute in that case, that the estimated gross receipts per mile were the measure of the value of the property, and that the effort of the State was to reach that value, and not fasten on the receipts from transportation in the State and that this was shown in the scheme of the statute to establish assessment.
- In the case at bar we have shown that the State has already taxed plaintiff's property at its actual value as a going con-

cern; that in taxing the operating revenue of the plaintiff it not only attempts to but actually does tax the interstate business of the plaintiff, and the tax, therefore, bears directly upon interstate commerce and amounts to a regulation of it as stated in the above case.

This tax is void as being a regulation of interstate commerce and is in direct conflict with the decisions of the Supreme Court in the following cases :

- State Franchise Tax Case, 15 Wallace, 232.
- State Tax on Railroad Gross Receipts, 15 Wallace, 284.
- Fargo v. Michigan, 121 U. S., 230.
- Philadelphia & M. S. Co. v. Pennsylvania, 122 U. S., 326.
- Leloup v. Port of Mobile, 127 U. S., 640.
- Western Union Telegraph Company v. Alabama, 132 U. S., 472.
- Fargo v. Hart, 193 U. S., 490.
- Western Union Telegraph Company v. Kansas, 216 U. S., 1.
- Pullman Company v. Kansas, 216 U. S., 56.
- Ludwig v. Western Union Telegraph Company, 216 U. S., 146.
- Flint v. Stone Tracy Company, 220 U. S., 107.
- Meyer, Auditor of State of Oklahoma, v. Wells Fargo Co., 223 U. S., 298.
- Choctaw, Oklahoma & Gulf Ry. Co. v. Harrison, 235 U. S., 292.
- Looney v. Crane, 245 U. S., 178.
- International Paper Company v. Massachusetts, 246 U. S., 145.
- Wallace v. Hines, 253 U. S., 66.
- Royster v. Virginia, 253 U. S., 412.
- Davis, Director General, v. Wallace, decided January 9th, 1922.
- Gillespie v. Oklahoma, decided January 20th, 1922.

In Crew Levick Company v. Pennsylvania. 245 U. S., at

page 294 the Court calls attention to the fact that while it accepts the decision of the State Court of last resort respecting the proper construction of state statutes, it is in duty bound to determine the question raised under the Federal Constitution upon its own judgment *of the actual operation and effect of any tax irrespective of the form it bears or how it is characterized by the State Court.* This case involved a tax upon the business of vending merchandise graduated according to the gross annual volume of business transacted and it was shown that the plaintiff in error was engaged in foreign commerce and the receipts were from that source. The tax was held void for that reason.

In *William E. Peck v. Lowe*, 247 U. S., 165, the Court had under consideration the Income Tax Act of the United States which was attacked upon the ground that it was a tax upon exports from one state to another. The Act was held valid, but the ground upon which it was held valid should not be lost sight of. We quote from the decision as follows:

"The tax in question is unlike any of those heretofore condemned. It is not laid on articles in course of exportation, or on anything which inherently or by the usages of commerce is embraced in exportation or any of its processes. On the contrary it is an income tax laid generally on net incomes. And while it cannot be applied to any income which Congress has no power to tax (see *Stanton v. Baltic Mining Co.*, 240 U. S., 554), it is both nominally and actually a general tax. *It is not laid on income from exportation because of its source, or in a discriminative way, but as it is just laid on other income.* The words of the Act are 'Net Income arising or accruing from all sources.' There is no discrimination. At most exportation is affected only indirectly and remotely. The tax is levied after exportation is completed, *after all expenses are paid and losses adjusted and after the receipt of the income is free to use it as he chooses.*" (Italics ours).

It will be noted that the tax as laid was not a tax on income

from exportation because of its source, but upon the income *after all expenses were paid and losses adjusted*. the Income Tax Act of North Carolina, we respectfully submit, is laid in a discriminatory way, because no corporations except those engaged as common carriers of interstate or foreign commerce by railroad, pipe line or of intelligence are taxed in the same way, and is a tax laid upon operating revenue, because of its source, for that all expenses and losses are not allowed to be deducted but only certain classes of expense designated by the Act.

The distinguishing features of the taxes involved in *Crew Levick Company v. Pennsylvania*, *supra*, held void, and *William E. Peck Company v. Lowe*, *supra*, held valid, are clearly defined in *United States Glue Co. v. Oak Creek*, 247 U. S., 321 at page 328, where Mr. Justice Brandeis for the Court says:

“The distinction between direct and indirect burdens, with particular reference to a comparison between a tax upon the gross returns of carriers in interstate commerce and a general income tax imposed upon all inhabitants, incidentally affecting carriers engaged in such commerce, was the subject of consideration in *Philadelphia & S. Mail Co. v. Pennsylvania*, 122 U. S., 345, where the Court, by Mr. Justice Bradley said: ‘The corporate franchise, the property, the business, the income of corporations created by a state, may undoubtedly be taxed by the state; but in imposing such taxes care should be taken not to interfere with or hamper, directly or by indirection, interstate or foreign commerce, or any other matter exclusively within the jurisdiction of the Federal Government.’ Many previous cases were referred to.

“The correct line of distinction is so well illustrated in two cases decided at the present term that we hardly need go further. In *Crew Levick Co. Pennsylvania*, 245 U. S., 292, we held that a state tax upon the business of selling goods in foreign commerce, measured, by a certain percentage of the gross transactions in such commerce, was

by its necessary effect a tax upon the commerce, and at the same time a duty upon exports, contrary to paragraphs 8 and 10 of Article 1 of the Constitution, since it operated to lay a direct burden upon every transaction by withholding for the use of the state a part of every dollar received. On the other hand, in *Peck & Co. v. Lowe*, 247 U. S., 165, we held that the income tax of October 3, 1913, chap. 16, paragraph 2, Stat. at L. 166, 172, when carried into effect by imposing an assessment upon the entire net income of a corporation, approximately three-fourths of which was derived from the export of goods to foreign countries, did not amount to laying a tax or duty on articles exported within the meaning of Art. 1, Sec. 9, cl. 5 of the Constitution. The distinction between a direct and an indirect burden by way of tax or duty was developed, and it was shown that an income tax laid generally on net incomes, *not on income from exportation but just as it was laid on other income, and affecting only the net receipts from exportation after all expenses were paid and losses adjusted and the recipient of the income was free to use it as he chose, was only an indirect burden.*" (Italics ours).

The fact that the Income Tax Act of North Carolina does not purport to lay a tax upon gross earnings does not affect its invalidity, for as shown, this Court must consider *the effect of the tax*, and the effect of this Act is to tax gross earnings, in that it does not allow to railroad companies those necessary items of expense in the production of the income such as expense rent for the use of property, interest paid and other expenses.

V.

THE ENTIRE SCHEME OF TAXATION IS ILLEGAL
BECAUSE IN VIOLATION OF THE UNIFORMITY
CLAUSE OF THE CONSTITUTION OF NORTH CARO-
LINA.

This Court in *Galveston, H. & A. R. R. v. Texas*, 210 U. S. 217, says:

"When a Legislature is trying simply to value property, it is less likely to attempt or to effect injurious regulation than when it is aiming directly at the receipts from interstate commerce. *A practical line can be drawn by taking the whole scheme of taxation into account. This must be done by this Court as best it can. Neither the State Courts nor the Legislatures, by giving a tax a particular name, or by the use of some form of words, can take away our duty to consider its nature and effect.*"
(Italics ours).

As said by the Court in this case it is necessary, therefore, to take into consideration the entire scheme of taxation established by the Legislature of North Carolina in order to understand and determine whether or not the scheme of taxation employed is, as a whole, legal. This scheme is as follows:

(1) The property of railroads in North Carolina is valued and assessed at its actual value as a whole as a going concern, and upon this is levied an ad valorem tax which goes to the counties, cities, towns and other taxing districts.

(2) Upon this same valuation and assessment at actual value as a going concern there is then levied a tax of one-tenth of one per cent for State purposes.

Of course these two assessments take in the entire property of the plaintiff, real, personal and intangible, as a going concern and at full value, and necessarily include the mileage proportion in the State of interstate Commerce, because that proportion of intangible value is arrived at under the statute from earnings. Therefore, the property as a going concern,

including earnings derived from interstate commerce, is taxed by these two methods.

(3) There is then levied another tax superimposed upon these two taxes, and that is this so-called Income Tax, which, when applied to railroads keeping their accounts in accordance with the standard classification of accounting of the Interstate Commerce Commission, is nothing more nor less than a tax upon the gross receipts derived from interstate commerce from which is deducted:

- (a) Uncollectible revenue.
- (b) Taxes paid in the State other than income taxes and war profits and excise profits taxes, and
- (c) Car hire.

This scheme of taxation is in violation of the Constitution of North Carolina.

The Constitution of North Carolina provides, Section 3 of Article 5, and Section 9 of Article 7, that the State, county, town and township taxes shall be uniform and ad valorem upon all property in the same except property exempt by this Constitution. We say that it shall be ad valorem because Section 3 says:

"Laws shall be passed taxing by a uniform rule all moneys, credits, investments in bonds, stocks, joint stock companies, or otherwise; and also all real and personal property according to its true value in money."

The Legislature of North Carolina, in the Revenue Act of 1921, Section 3, violates this provision of the Constitution, because it levied no tax on any such property in the State for the uses of the State government. This section is as follows:

"Sec. 3. State taxes. No tax on any property in the State shall be levied for any of the uses of the State Government. The taxes hereinafter levied in this act are for the expenses of the State Government, the appropriations to its educational, charitable, and penal institutions, pen-

sions for Confederate soldiers and widows, the interest on the debt of the State, an equalizing fund for public schools, and other specific appropriations made by law, and shall be collected and paid into the general fund of the State Treasurer."

When the Legislature of North Carolina undertakes, in violation of the express terms of the Constitution, to set up a taxing system prohibited by the Constitution, it necessarily is illegal.

The plain mandate of the Constitution provides that uniform ad valorem taxes shall be levied on real and personal property for State, county, city and township taxes.

That the Legislature has not the discretionary power to levy or not levy these ad valorem taxes on all real and personal property has been consistently confirmed by the decisions of this Court. The rule is stated in *Commissioners v. Tobacco Co.*, 116 N. C., at page 446 by Chief Justice Clark, then Associate Justice, as follows:

"As to corporations, by all the authorities, it is in the power of the legislature to lay the following taxes, two or more of them in its discretion at the same time: 1. To tax the franchise (including in this the power to tax also the corporate dividends). 2. The capital stock. 3. The real and personal property of the corporation. *This tax is imperative and not discretionary under the ad valorem feature of the Constitution.* 4. The shares of stock in the hands of the stockholder. This is also imperative and not discretionary." (Italics added).

"The Constitution, Art. 5, Sec. 3, commands that: Laws shall be passed taxing by a uniform rule all moneys, credits, investments in bonds, stocks, joint stock companies, or otherwise; and also all real and personal property according to its true value in money. It is apparent from an examination of the taxing laws of the State that the legislative department has attempted to observe and enforce *the mandate of the Constitution.*" (Italics added).

To the same effect are found exp
following cases :

ssion, 152 N. C., page 553.

Pullen v. Corporation Comm¹⁴⁰.

Smith v. Wilkins, 164 N. C. C., at page 214.

Guano Co. v. Biddle, 158 N. C., at page 573.

C., 165.

Lacy v. Packing Co., 134 N. C., 177 N. C., 430.

Railroad v. New Bern, 147 N. C., 445.

Bickett v. Tax Commission, C., 10.

Kyle v. Commissioners, 75 N.

R. R. v. Commissioners, 72 , city, town or township
upon all property in the

"All taxes levied by any coun^{this constitution.}" Art.
shall be uniform and ad valorem
same, except property exempted Elmond v. Commissioners,
VII, Sec. 9. held that it was not in-

In construing this section in Rity to the subjects alone
106 N. C., 122, the Supreme Couion in granting a munici-
tended to apply the rules of uniforerty in the municipality
selected by the Legislature for taxaly and equal. In the
pal charter but requires that all p^{erd says:}
shall be taxed, and taxed unifor
opinion of the Court, Justice Shem the Legislature, and it

"In the absence of constitut^{against a particuar class}
is said, no restraint whatever ^{laws in violation of every}
may discriminate in favor of ^{an unequal distribution}
of persons or property, and pa^{upon such an abuse of}
principle of just government, ^{constituents over their}
of the public burdens. The cl^{of authority is that the}
power is in the influence of ^{with this exercise of the}
representatives; and the weighd is open for a war be-
courts have no right to interfecy, in that one class may
legislative will. ^{he prejudice of another,}

Thus it is seen that a widee government, an excited
tween different classes of prop
be taxed to the exclusion or t
and that under the forms of a

partisan legislative majority may commit wrongs against the rights of property as flagrant and oppressive as those which have disgraced the reigns of the most despotic rulers.

But it is said that the General Assembly will be influenced by proper motives, and will levy taxes upon a just basis. Experience, in many of the states, has shown that the principles of taxation should not be left to the uncertainty or caprice of successive legislatures, but that they should be fixed and immutable, and embodied in the fundamental law, under whose broad shield all property, of whatsoever species, may be protected.

This, we think, was the purpose of the framers of our Constitution in inserting therein the section referred to, as well as Section 3, Art. 5, relating to State taxation.

No one who reads these and other provisions of the Constitution will fail to be impressed with the earnest effort there made to engraft upon our organic law the great principle of equality in taxation."

The Legislature has seen fit to violate the express provisions of the Constitution of North Carolina and levied no tax whatever on moneys, credits, investments in bonds, stocks, joint stock companies, or real and personal property for State purposes. It has, in violation of this provision of the Constitution, delegated to the counties and cities the right to levy taxes for these purposes, and in order to make up the deficit for the State Treasury, created by this system of taxation, it proposes, for State purposes, to levy an income tax and tax upon corporations of every class and character.

We have already referred the Court to the Redmond case, and quoted fully from that case to show that these provisions of the Constitution are mandatory. This scheme of taxation is predicated upon the desire to take from the earnings of corporations, and especially of public service corporations in North Carolina, a greater amount in taxation in proportion to their property values than other citizens of the State. The

farmer is exempt from paying any tax upon his farm for the operating expenses of the State government. No scheme of taxation not authorized by the Constitution of the State can exist.

As said by Justice Shepherd in the Redmond case, after referring to various cases:

"These cases decide that, when the taxing power is exercised for a public purpose, *the Constitution, and not the Legislature, declares what property shall be taxed, and by a uniform rule, and ad valorem.*"

In that case there was a question of the taxation of personal property. He then further says:

"All taxes, therefore, must be levied as well on personal as on real property."

This being the interpretation of the Constitution of North Carolina by the Supreme Court of that State, it is binding upon this Court.

There was no power or authority in the Legislature to put into effect a scheme of taxation in violation of the mandate of the Constitution.

We respectfully submit, therefore, that the tax is invalid and that plaintiff is entitled to an interlocutory injunction, and the decree of the District Court should be reversed.

THOMAS W. DAVIS,

Solicitor for Appellant.

GEO. B. ELLIOTT,

HARRY SKINNER,

Of Counsel,

Wilmington, N. C., March 9th, 1923.

APPENDIX

Extracts from

Constitution of North Carolina:

Article V.

Section 3. Taxation

Valorem: Exemptionon Shall be by Uniform Rule and ad uniform rule all moneys.—Laws shall be passed taxing by a joint stock companies, credits, investments in bonds, stocks, personal property, accs, or otherwise; and also all real and

* * * The General Assembly may also tax trades, profes-

"Section 6. Taxes incomes," etc.

State and county tax cents on the one hundred when the county property and with the special which may be done by limitation shall not apply of the public schools article nine, section further, the state tax hundred dollars value

Levied for Counties.—The total of the tax on property shall not exceed fifteen hundred dollars value of property, except property tax is levied for a special purpose by approval of the General Assembly, by special or general act: Provided, this shall not apply to taxes levied for the maintenance of the State for the term required by article three, of the Constitution: Provided, the tax shall not exceed five cents on the one hundred of property."

"Section 9.—All tax-
payers in any city or township shall be u-
nder the same liability in the same excep-
tion."

Article VII.

erty in the same except taxes levied by any county, city, town or township shall be uniform and ad valorem upon all prop-

Extracts from Consider

cept property exempted by this Constitu.

Section 7979. Remed

Unless a tax or assessment is levied by the Taxpayer for unauthorized tax-
or invalid, or be levied by the Taxpayer for unauthorized tax-
ized purpose, no injunction, or some part thereof, be illegal
or judge to restrain the collection thereof for an illegal or unauthor-
nor to restrain the collection thereof shall be granted by any court
the collection thereof in whole or in part.
the collection thereof in whole or in part.
the collection thereof in whole or in part.

thereof; nor shall any court issue any order in claim and delivery proceedings or otherwise for the taking of any personalty levied on by the sheriff to enforce payment of such tax or assessment against the owner thereof. Whenever any person shall claim to have a valid defense to the enforcement of a tax or assessment charged or assessed upon his property or poll, such person shall pay such tax or assessment to the sheriff; but, if, at the time of such payment, he shall notify the sheriff in writing that he pays the same under protest, such payment shall be without prejudice to any defenses or rights he may have in the premises, and he may, at any time within thirty days after such payment, demand the same in writing from the Treasurer of the State or of the county, city, or town, for the benefit or under the authority or by request of which the same was levied; and if the same shall not be refunded within ninety days thereafter, may sue such county, city, or town for the amount so demanded, including in his action against the county both State and county tax; and if, upon the trial it shall be determined that such tax or any part thereof was levied or assessed for an illegal or unauthorized purpose, or was for any reason invalid or excessive, judgment shall be rendered therefor, with interest, and the same shall be collected as in other cases. The amount of State taxes for which judgment shall be rendered in such action shall be refunded by the State Treasurer.

EXTRACTS FROM REVENUE ACT OF NORTH CAROLINA

Ch. 34, Public Laws, 1921

Sec. 3. State taxes.

No tax on any property in the State shall be levied for any of the uses of the State Government. The taxes hereinafter levied in this act are for the expenses of the State Government, the appropriations to its educational, charitable, and penal institutions, pensions for Confederate soldiers and wid-

ows, the interest on the debt of the State, an equalizing fund for public schools, and other specific appropriations made by law, and shall be collected and paid into the general fund of the State Treasurer.

Sec. 64. Tangible and intangible property assessed separately.

(a) At such dates as real estate is required to be assessed for taxation, the said commission shall first determine the value of the tangible property of each division or branch of such railroad of rolling stock and all other physical or tangible property. This value shall be determined by a due consideration of the actual cost of replacing the property, with a just allowance for depreciation on rolling stock, and also of other conditions, to be considered as in the case of private property.

(b) They shall then assess the value of the franchise, which shall be determined by due consideration of the gross earnings as compared with the operating expenses, and particularly by consideration of the value placed upon the whole property by the public (the value of the physical property being deducted), as evidenced by the market value of all capital stock, certificates of indebtedness, bonds, or any other securities, the value of which is based upon the earning capacity of the property.

(c) The aggregate value of the physical or tangible property and the franchise as thus determined, shall be the true value of the property for the purpose of an ad valorem taxation, and shall be apportioned in the same proportion that the length of such road in each county bears to the entire length of such division or branch thereof; and the State Tax Commission shall certify, on or before the first day of September, to the chairman of the county commissioners and the mayor of each city or incorporated town the amount apportioned to his county, city or town: all taxes due the State from any railroad company shall be paid by the treasurer of each company directly to the State Treasurer within thirty days after the first day of July of each year; and upon failure to pay the

State Treasurer as aforesaid, he shall institute an action to enforce the same in the county of Wake or any other county in which such railroad is located, adding thereto twenty-five per centum of the tax. The board of county commissioners of each county through which said railroad passes shall assess against the same only the tax imposed for each county, township, or other taxing district purposes, the same as is levied on other property in such county, township, or special taxing districts.

Sec. 6. Railroads.

When any railroad has part of its road in this State and part thereof in any other State, the said commission shall ascertain the value of railroad track, rolling stock, and all other property liable to assessment by the State Tax Commissioner of such company as provided in the next proceeding section, and divided in the proportion to the length such main line or road in this State bears to the whole length of such main line of road, and determine the value in this State accordingly: Provided, the commission shall, in valuing the fixed property in this State, give due consideration to the character of the roadbed and fixed equipment, number of miles of double track, the amount of gross and net earnings per mile of road in this State, and any other factor which would give a greater or less value per mile of road in this State than the average value for the entire system. On or after the first Monday in July the said commission shall give a hearing to all the companies interested, touching the valuation and assessment of property. The said commission may, if they see fit, require all argument and communications to be presented in writing.

Sec. 82 (61½). Railroads.

Every railroad company doing business in this State shall annually on or before the thirtieth day of July make and return to the State Tax Commission, in such form and upon such blanks as shall be furnished by the State Tax Com-

mission, and giving such information as the State Tax Commission shall require, for the purpose of carrying out the provisions of this section, and upon which report the State Tax Commission shall ascertain and certify to the State Auditor the value upon which the amount of taxes which shall be paid by any such railroad company as a franchise or privilege tax shall be calculated. The basis upon which such calculation shall be made by the State Tax Commissioner and the extent to which every such railroad company is exercising its franchise in this State shall be found to be the value of the property, tangible and intangible, of each such railroad company in the State assessed for the year in which such report is made for ad valorem taxes. The franchise tax of each such railroad franchise in this State shall be one-tenth of the one per cent (0.1%) of the value so ascertained by the State Tax Commission, and such tax shall be due and payable on or before the fifteenth day of October in each year. If any such company shall fail to make the report provided for, it shall be the duty of the State Tax Commission to make an approximation from the reports and records on file in that department of the amount of taxes due under this section, and certify same to the State Auditor and Treasurer for collection. No county, city or town shall be allowed to collect any taxes under this section.

"Sec. 101. Purpose. The general purpose of this act is to impose a tax, for the use of the State Government, upon the net income for the calendar year 1921, in excess of the exemptions herein set out, collectible in the year 1922, and annually thereafter: (a) Of every citizen of the State. (b) Of every domestic corporation. (c) Of every foreign corporation and of every non-resident individual having a business or agency in this State, in proportion to the net income of such business or agency.

Except as otherwise provided in this act the purpose is to conform to the definitions of income in the revenue laws of the United States Government and regulations made under its authority, in so far as they apply.

The tax imposed upon the net income of corporations in this schedule is in the nature of a franchise tax for the privilege granted by the State to domestic corporations and to foreign corporations doing business in this State, and is in addition to the tax imposed under Schedule C of this act."

"Sec. 102. Definitions. For the purpose of this act and unless otherwise required by the context:

1. The words "Tax Commission" mean the State Tax Commission.

2. The word "taxpayer" includes the individual, corporation or fiduciary subject to the tax imposed by this act.

3. The word "individual" means a natural person.

4. The word "fiduciary" means a guardian, trustee, executor, administrator, receiver, conservator, or any person, whether individual or corporation, acting in any fiduciary capacity for any person, estate or trust.

5. The word "person" includes individuals, fiduciaries, partnerships and corporations.

6. The word "corporation" includes joint-stock companies or associations and insurance companies.

7. The words "domestic corporation" mean any corporation organized under the laws of this State.

8. The words "foreign corporation" mean any corporation other than a domestic corporation.

9. The words "tax year" mean the calendar year in which the tax is payable.

10. The words "income year" mean the calendar year or the fiscal year, upon the basis of which the net income is computed under this act: if no fiscal year has been established they mean the calendar year.

11. The words "fiscal year" mean an income year, ending on the last day of the month other than December.

12. The word "paid" for the purposes of the deductions under this act means "paid or accrued" or "paid or incurred," and the words "paid or accrued," "paid or incurred," and "incurred," shall be construed according to

the method of accounting upon the basis of which the net income is computed under this act. The word "received" for the purpose of the computation of the net income under this act means "received or accrued," and the words "received or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under this act.

13. The word "resident" applies only to individuals, and includes for the purpose of determining liability to the tax imposed by this act, with reference to the income of any income year, any individual who shall be a resident of the State on the first day of the tax year. In the absence of other satisfactory indicia the residence of a person who has two or more places in which he occasionally dwells may be determined with reference to the place at which the individual lived the longest period of time during the income year.

14. The words "foreign country" mean any jurisdiction other than one embraced within the United States. The words "United States," when used in a geographical sense, include the States, the Territories of Alaska and Hawaii, the District of Columbia, and the possessions of the United States."

"Sec. 201. Corporations. Every corporation organized under the laws of this State shall pay annually a franchise or excise tax, with respect to carrying on or doing business, equivalent to three per cent of the entire net income of such corporation, as herein defined, received by such corporation during the income year; and every foreign corporation doing business in this State shall pay annually a franchise or excise tax equivalent to three per cent of a proportion of its entire net income, to be determined according to the following rules:

This section was amended on December 19th, 1921, at the special session of the Legislature of North Carolina of 1921, being Chapter 102 of the Public Laws of North Carolina, Special Session 1921, as follows:

"Section 201. Corporations. Every corporation organized under the laws of this State shall pay annually an income tax equivalent to three per cent of the entire net income of such corporation, as herein defined, received by such corporation during the year; and every foreign corporation doing business in this State shall pay annually an income tax equivalent to three per cent of a proportion of its entire net income, to be determined according to the following rules."

In case of a company other than companies mentioned in the next succeeding section, deriving profits principally from the ownership, sale or rental of real estate or from the manufacture, sale, or use of tangible personal property such proportion of its entire net income as the fair cash value of its real estate and tangible personal property in this State on the date of the close of the fiscal year of such company in the income year is to the fair cash value of its entire real estate and tangible personal property then owned by it, with no deduction on account of incumbrances thereon.

In case of a corporation deriving profits principally from the holding or sale of intangible property, such proportion as its gross receipts in this State for the year ending on the date of the close of its fiscal year next preceding is to its gross receipts for such year without the State."

Sec. 202. Railroads and Public Service Corporations. The basis of ascertaining the net income of every corporation engaged in the business of operating a steam or electric railroad express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the standard classification of the accounting of the Interstate Commerce Commission, shall be the 'net operating income' of such corporations as shown by their records kept in accordance with that standard classification of accounts, when their business is wholly within this State, and when their business is in part

within and part without the State their net income within this State shall be ascertained by taking their gross 'operating revenues' within this State, including in their gross 'operating revenues' within this State the equal mileage proportioned within this State of their interstate business and deducting from their gross 'operating expenses,' or 'operating ratio,' for their whole business, as shown by the Interstate Commerce Commission standard classification of accounts. From the net operating income thus ascertained shall be deducted 'uncollectible revenue,' and taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes, and the balance shall be deemed to be their net income taxable under this act."

"Sec. 203. Such tax shall first be levied, collected, and paid in the year 1922, and with respect to the net income received during the calendar year 1921 or during any income year ending during the twelve months ending March 31, 1922."

"Sec. 300. Net income defined. The words 'net income' mean the gross income of a taxpayer less the deductions allowed by this act."

"Sec. 301. Gross income defined. 1. The words 'gross income' include gains, profits and income derived from salaries, wages or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, business, commerce or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gains or profits, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income of the income year in which received by the taxpayer, unless, under the methods of accounting permitted under this act, any such amounts are to be properly accounted for as of a different period.

2. The words 'gross income' do not include the following items, which shall be exempt from taxation under this act.

(a) The proceeds of life insurance policies and contracts paid upon the death of the insured to individual beneficiaries or to the estate of the insured.

(b) The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract.

(c) The value of property acquired by gift, bequest, devise or descent (but the income from such property shall be included in gross income).

(d) Interest upon the obligations of the United States or its possessions, or of the State of North Carolina.

(e) Salaries, wages, or other compensation received from the United States by officials or employees thereof, including persons in the military or naval forces of the United states.

(f) Any amounts received through accident or health insurance or under workman's compensation acts, as compensation for the personal injuries or sickness, plus the amount of any damages received, whether by suit or agreement, on account of such injuries or sickness."

"Sec. 306. Deductions. In computing net income there shall be allowed as deductions:

1. All the ordinary and necessary expenses paid during the income year in carrying on any trade or business including:

(a) As to individuals, wages of employees for service actually rendered in producing such income.

(b) As to partnerships, wages of employees and a reasonable allowance for copartners or members of a firm, for services actually rendered in producing such income, the amount of such salary allowance to be included in the personal return of the copartner receiving same.

(c) As to corporations, wages of employees and salaries of officers, if reasonable in amount, for services actually rendered in producing such income.

2. Rentals or other payments required to be made as a condition of the continued use or possession, for the purposes of the trade of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

3. All interest paid during the income year on indebtedness except interest on obligations contracted for the purchase of non-taxable securities. Dividends on preferred stock shall not be deducted as interest.

4. Taxes for the income year, except taxes on income and war profits, and excess profits taxes, inheritance taxes, and taxes assessed for local benefit of a kind tending to increase the value of the property assessed.

5. Dividends from stock in any corporation the income of which shall have been assessed and the tax on such income paid by the corporation under the provisions of this act: Provided, that when only a part of the income of any corporation shall have been assessed under this act only a corresponding part of the dividends received therefrom shall be deducted.

6. Losses sustained during the income year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit.

7. Debts ascertained to be worthless and charged off within the income year, if the amount has previously been included in gross income in a return under this act.

8. A reasonable allowance for the depreciation and obsolescence of property used in the trade or business; and, in the case of mines, oil, and gas wells, other natural deposits, and timber, a reasonable allowance for depletion: Provided, that in computing the deductions allowed under this paragraph, the basis shall be the cost (including in the case of mines, oil and gas wells, and other natural deposits, the cost of development, not otherwise deducted), and in the

case of property acquired prior to January 1, 1921, the fair market value of the property (or the taxpayer's interest therein) on that date and shall be taken in lieu of cost up to that date. The reasonable allowances under this paragraph shall be made under rules and regulations to be prescribed by the Tax Commission. In the cases of leases the deductions allowed may be equitably apportioned between the lessor and lessee.

9. In the case of taxpayers who keep regular books of account, upon an accrual basis and in accordance with standard accounting practice, reserves for bad debts and for contingent liabilities, under such rules and restrictions as the Tax Commission may impose. If the Tax Commission shall at any time deem the reserve excessive in amount it may restore such excess to income, either in a subsequent year or as a part of the income of the income year and assess it accordingly.

10. Contributions or gifts made within the taxable year to corporations or associations operating exclusively for religious, charitable, scientific or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, to an amount not in excess of fifteen per centum of the taxpayer's net income as computed without the benefit of this subdivision.

11. Resident individuals having an established business in another State, or investment in property in another State, may deduct the net income from such business or investment, if such business or investment is in a State that levies a tax upon such income. The deduction authorized in this subsection shall in no case extend to any part of income of resident individuals from personal services, or mortgages, stocks, bonds, securities and deposits.

12. In the case of a nonresident individual, the deductions allowed in this section shall be allowed only if, and to the extent that, they are connected with income arising

from sources within the State; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the State shall be determined under rules and regulations prescribed by the State Tax Commission."

ARTICLE VI

Penalties

Sec. 600. Penalties. 1. If any taxpayer, without intent to evade any tax imposed by this act shall fail to file a return of income or pay a tax, if one is due, at the time required by or under the provisions of this act, but shall voluntarily file a correct return of income and pay the tax due within sixty days thereafter, there shall be added to the tax an additional amount equal to five percent thereof, but such additional amount shall in no case be less than one dollar and an additional one per cent for each month or fraction of a month during which the tax remains unpaid.

2. If any taxpayer fails voluntarily to file a return of income or pay a tax, if one is due, within sixty days of the time required by or under the provisions of this act, the tax shall be doubled, and such double tax shall be increased by one per cent for each month or fraction of a month from the time the tax was originally due to the date of payment.

3. The Tax Commission shall have power, upon making a record of its reasons therefor, to waive or reduce any of the additional taxes or interest provided in subdivisions 1 and 2 of this section, or in subdivisions 2, 3, and 4 of section 501.

4. If any taxpayer fails to file a return within sixty days of the time prescribed by this act, any judge of the Superior Court, upon petition of the Tax Commission, or of any ten taxable residents of the State, shall issue a writ of mandamus requiring such person to file a return. The order of notice upon the petition shall be returnable not later than ten days after the filing of the petition. The petition shall be heard and determined on the return day or on such day

thereafter as the Court shall fix, having regard to the speediest possible determination of the case, consistent with the rights of the parties. The judgment shall include costs in favor of the prevailing party. All writs and processes may be issued from the clerk's office in any county and, except as aforesaid, shall be returnable as the Court shall order.

5. Any person who, without fraudulent intent, fails to pay any tax or to make, render, sign or verify any return, or to supply any information, within the time required by or under the provisions of this act, shall be liable to a penalty of not more than one thousand dollars, to be recovered by the Attorney General, in the name of the people, by action in any court of competent jurisdiction.

6. Any person or officer or employee of any corporation, or member or employee of any partnership, who, with intent to evade any requirement of this act, or any lawful requirement of the Tax Commission thereunder, shall fail to pay any tax or to make, sign, or verify any return, or to supply any information required by or under the provisions of this act, or who, with intent, shall make, render, sign, or verify any false or fraudulent return or statement, or shall supply any false or fraudulent information, shall be liable to a penalty of not more than one thousand dollars, to be recovered by the Attorney General in the name of the people, by action in any court of competent jurisdiction, and shall also be guilty of a misdemeanor, and shall, upon conviction, be fined not to exceed one thousand dollars or be imprisoned not to exceed one year, or both, at the discretion of the Court.

7. The Attorney General shall have the power, with the consent of the Tax Commission, to compromise any penalty for which he is authorized to bring action under subdivisions 5 and 6 of this section. The penalties provided by such subdivision shall be addition to all other penalties in this act provided.

8. The failure to obey any act required by or under the provisions of this act shall be deemed an act committed in

part at the office of the Tax Commissioner in Raleigh. The certificate of the Tax Commission to the effect that a tax has not been paid, that a return has not been filed, or that information has not been supplied, as required by or under the provisions of this act, shall be prima facie evidence that such tax has not been paid, that such return has not been filed, or that such information has not been supplied.

9. If any taxpayer who has failed to file a return, or has filed an incorrect or insufficient return, and has been notified by the Tax Commission of his delinquency, refuses or neglects within twenty days after such notice to file a proper return, or files a fraudulent return, the Tax Commission shall determine the income of such taxpayer, according to its best information and belief, and assess the same at not more than double the amount so determined. The Tax Commission may, in its discretion, allow further time for the filing of a return in such case.

ARTICLE VII

Revision and Repeal

Sec. 700. Revision by Tax Commission. A taxpayer may apply to the Tax Commission for revision of the taxes assessed against him, at any time within one year from the time of the filing of the return or from the date of the notice of the assessment of any additional tax. The Tax Commission shall grant a hearing thereon, and if, upon such hearing, it shall determine that the tax is excessive or incorrect, it shall resettle the same according to the law and the facts and adjust the computation of tax accordingly. The Tax Commission shall notify the taxpayer of its determination and shall refund to the taxpayer the amount, if any paid in excess of the tax found by it to be due. If the taxpayer has failed, without good cause, to file a return within the time prescribed by law, or has filed a fraudulent return, or, having filed an incorrect return, has failed, after notice, to file a proper return, the Tax Commission shall not reduce the tax below double the

amount for which the taxpayer is found to be properly assessed.

Sec. 701. Appeal. Any taxpayer may file formal exceptions to finding by the State Tax Commission with respect to his taxable income, and upon such exceptions being overruled, any such taxpayer shall have the right, upon the payment of the amount of tax found by the State Tax Commission to be due, and upon filing bond for cost in the sum of two hundred dollars, to have the record in such case certified to the Superior Court of the county in which the taxpayer resides, or has his principal place of business, within thirty days after notice by the Tax Commission of its determination, given as provided in section 700 of this act. Thereupon, appropriate proceedings shall be had and the relief, if any, to which the taxpayer may be found entitled may be granted and any taxes, interest or penalties paid, found by the Court to be in excess of those legally assessed, shall be ordered refunded to the taxpayer, with interest from time of payment

Chapter 96. Public Laws of North Carolina, Extra Session 1921.

"Section 1. Whenever taxes of any kind are or have been through clerical error, or misinterpretation of the law, or otherwise, collected and paid into the State Treasury in excess of the amount legally due the state, the State Auditor shall issue a warrant for the amount so illegally collected, to the person entitled thereto, upon certificate of the head of the department through which said taxes were collected or his successor in the performance of the functions of that department, with the approval of the Attorney General, and the Treasurer shall pay the same out of the funds in the treasury not otherwise appropriated: Provided, demand is made for the correction of such error or errors within two years from the time of such payment: Provided further, that claims which have arisen within the five years next preceding the ratification of this act shall be presented

and made within two years from the ratification of this act,

"Sec. 2. This act shall be in force and effect from and after its ratification.

"Ratified this 19th day of December, A. D., 1921."

CHAP. 40, PUBLIC LAWS 1921.

AN ACT TO TRANSFER THE POWERS AND DUTIES OF THE STATE TAX COMMISSION TO THE STATE DEPARTMENT OF REVENUE.

The General Assembly of North Carolina do enact :

Section 1. From and after the first day of May, one thousand nine hundred and twenty-one, all the powers and duties imposed by any act of law, including Revenue and Machinery Acts, enacted by the present session of the General Assembly, upon the State Tax Commission, shall be transferred to and imposed upon the department to be known as the State Department of Revenue, created by this act, to be administered by the Commissioner of Revenue, to be appointed as provided in this act. All such powers and duties, except as otherwise provided herein, shall devolve upon the Commissioner of Revenue, and wherever in the revenue laws of the State the words "State Tax Commission" are used such words shall, after May first, one thousand nine hundred and twenty-one, be held to mean Commissioner of Revenue, except as otherwise provided in this act.

Sec. 2. There is hereby created the office of Commissioner of Revenue, to be appointed by the Governor, by and with the advice and consent of the Senate, and if such appointment is made when the Senate is not in session, confirmation may be by the Senate at the next session. The term of office shall be for four years from and after the first day of May, one thousand nine hundred and twenty-one, and the succeeding commissioner of revenue shall be nominated and elected in the year one thousand nine hundred and twenty-four, in the

manner provided for the nomination and election of other State officers, and quadrennially thereafter.

Sec. 3. The powers and duties now exercised by the State Tax Commission as a State Board of Equalization, and the appellate authority exercised by the said Tax Commission in determining appeals from the valuation made by assessing officers in the several counties of the State, shall, from and after the first day of May, one thousand nine hundred and twenty-one, be held and exercised by a State Board of Equalization, composed of the Commissioner of Revenue, the chairman of the Corporation Commission, and the Attorney-General, who shall be ex officio members of and constitute the State Board of Equalization, to have and exercise the powers and duties now imposed by law upon the State Tax Commission as a State Board of Equalization, and as an appellate court, to hear and determine appeals from valuation of property by assessing officers in the several counties. The said board shall meet upon call of the Commissioner of Revenue as often as may be necessary to discharge the duties imposed by law upon the said board.

U. S. Supreme Court, U. S.
FILED

MAR 31 1923

WM. R. STANSBURY
CLERK

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1922.

No. 724.

ATLANTIC COAST LINE RAILROAD COMPANY, APPELLANT,

v.

A. D. WATTS, COMMISSIONER OF REVENUE OF THE STATE OF NORTH CAROLINA, AND OTHERS.

No. 727.

NORFOLK SOUTHERN RAILROAD COMPANY, APPELLANT,

v.

A. D. WATTS, COMMISSIONER OF REVENUE OF THE STATE OF NORTH CAROLINA, AND OTHERS.

No. 744.

SEABOARD AIR LINE RAILWAY COMPANY, APPELLANT,

v.

A. D. WATTS, COMMISSIONER OF REVENUE OF THE STATE OF NORTH CAROLINA, AND OTHERS.

No. 756.

THE SOUTHERN RAILWAY COMPANY, APPELLANT,

v.

A. D. WATTS, COMMISSIONER OF REVENUE OF THE STATE OF NORTH CAROLINA, AND OTHERS.

APPEALS FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE EASTERN DISTRICT OF NORTH CAROLINA.

BRIEF ON BEHALF OF THE APPELLEES.

JAMES S. MANNING,

Attorney General of North Carolina;

FRANK NASH,

Assistant Attorney General of North Carolina,

Holders for the Appellees.

WM. F. BYNUM,

GEORGE H. BROWN,

LOCKE CRAIG,

THOMAS D. WARREN,

DWIGHT S. ALDERMAN,

Of Counsel for the Appellees.

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SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1922.

No. 724.

ATLANTIC COAST LINE RAILROAD COMPANY, APPELLANT,
v.

A. D. WATTS, COMMISSIONER OF REVENUE OF THE STATE OF NORTH
CAROLINA, AND OTHERS.

No. 727.

NORFOLK SOUTHERN RAILROAD COMPANY, APPELLANT,
v.

A. D. WATTS, COMMISSIONER OF REVENUE OF THE STATE OF NORTH
CAROLINA, AND OTHERS.

No. 744.

SEABOARD AIR LINE RAILWAY COMPANY, APPELLANT,
v.

A. D. WATTS, COMMISSIONER OF REVENUE OF THE STATE OF NORTH
CAROLINA, AND OTHERS.

No. 756.

THE SOUTHERN RAILWAY COMPANY, APPELLANT,
v.

A. D. WATTS, COMMISSIONER OF REVENUE OF THE STATE OF NORTH
CAROLINA, AND OTHERS.

APPEALS FROM THE DISTRICT COURT OF THE UNITED
STATES FOR THE EASTERN DISTRICT OF NORTH CARO-
LINA.

BRIEF ON BEHALF OF THE APPELLEES.

Statement of the Case.

These four appeals involve precisely the same matter, the
power of the Legislature of North Carolina to enact the In-

come Tax Act of 1921 as applied to railroads engaged in interstate commerce. The district court upon final hearing held the statute valid, refused injunctions, and dismissed the complaints. The plaintiffs appeal to this court direct under section 238 of the Judicial Code for a review of the district court's decision as to constitutionality of the statute.

In the North Carolina Railroad Tax Cases (*Southern Railway Company v. Watts*), decided at this term, the same plaintiffs attacked the validity of this Income Tax Statute together with the validity of the *ad valorem* assessments and the franchise or privilege tax. Upon intimation of the district courts in those cases that the validity of the income tax was not properly before the court, these four plaintiffs brought these separate suits in the Eastern District of North Carolina to raise that one question. In the appeals of the former cases this court decided against the appellants several of the contentions upon which they attack the validity of the Income Tax Act in these suits. The tax here involved is the only part of North Carolina's taxing system as to railroads upon which this court has not already passed.

Constitutional Provisions.

Prior to 1921 the authority of the General Assembly of North Carolina to levy an income tax was contained in section 3 of article V of the Constitution as follows:

"The General Assembly may also tax trades, professions, franchises, and incomes; *provided*, that no income shall be taxed when the property from which the income is derived is taxed."

A tax limited by that proviso was necessarily unproductive and its avails formed only a small part of the revenue of the State, in round numbers \$500,000.00. It was, therefore, a part of the general scheme for the revision of the taxing laws of the State to remove this constitutional limitation upon income taxation. At the extra session of August, 1920, by chapter 93 of the Public Laws of that session, the General Assembly submitted to the people for their approval or disapproval at the ensuing general election in November, 1920, the following amendment which was approved and became operative on January 7, 1921:

"1. Amend article five, section three, by repealing the proviso in said section 'that no income shall be taxed when the property from which the income is derived is taxed,' and substituting in lieu thereof the following: *Provided*, the rate of tax on incomes shall not in any case exceed six (6) per cent, and there shall be allowed the following exemptions to be deducted from the amount of annual incomes, to wit: for a married man with a wife living with him; or to a widow or widower having minor child or children, natural or adopted, not less than \$2,000; to all other persons not less than \$1,000, and there may be allowed other deductions (not including living expenses) so that only net incomes are taxed."

The Income Tax Statute.

Thereafter at the regular session of 1921 the General Assembly enacted as a part of the revenue laws of the State the Income Tax Act of 1921, the validity of which is here involved, Schedule D of the Revenue Act, chapter 34, Public Laws of 1921, being sections 100 to 904, inclusive, of that

act. It is set forth in full in the complaints and in the briefs of the appellants.

This statute taxed income earned during the calendar year of 1921, the tax being due and payable March 15, 1922. The net proceeds of the tax for 1921, excluding the amounts assessed on the appellants, the four largest railroads in the State, were \$2,408,000.00 in round numbers. The amounts assessed on these four railroads were: Southern, \$71,522.06; Seaboard, \$13,133.09; Atlantic Coast Line, \$41,686.96, and Norfolk Southern, \$19,616.46; a total for the four of \$145,959.54. This has not been and will not be paid pending the decision on these appeals.

The rate of the income tax is the same for all corporations—3 per cent of the net annual income from business within the State. From the necessity of the case, the statutory method of ascertaining what is the taxable net income differs in the case of individuals, ordinary corporations, and public-service corporations. In particular, this method necessarily differs in the cases of public-service corporations doing a business wholly within North Carolina, the total net income from which is taxed, and like corporations doing interstate business partly within and partly without the State, and only North Carolina's proportion of the net income from which is taxed.

The complication necessary as incident to the determination of this proportionate net income taxable by North Carolina in the case of interstate carriers is the reason for the principal classifications as to method of ascertainment of net income made by the statute.

As to all classes, it levies a tax on "net income," and it defines net income, in section 300, as being "the gross income

of a taxpayer, less the deductions allowed in this act." In section 301 the words "gross income" are defined by a statement of the items of revenue included within that term as taxable, and the items which are exempt from taxation and not to be comprehended within the term "gross income."

The principal classification is the division of taxpayers for purposes of ascertaining the taxable net income, into three classes: *first*, individuals; *second*, railroads and other public-service corporations "required to keep records according to the standard classification of accounting of the Interstate Commerce Commission;" *third*, other corporations.

As to the *first* class—individuals—the peculiarity is that they are allowed no deduction from gross income of personal, living, or family expenses (section 307). Consequently, individuals are required by the State to pay tax on their net incomes as defined by the act, although every cent of such income was expended for those absolutely necessary personal or family expenses without which the taxpayer or his family could not continue to exist. There is no corresponding provision as to corporations of any class, so that all corporations are allowed deductions for those necessary expenses without which the corporation could not continue its corporate life and business.

As to the *second* class, since the members thereof are required, either by the Interstate Commerce Commission or by State authority, to keep, and do keep, their records and accounts according to the very complete and excellent standard classification of accounting of the Interstate Commerce Commission, which standard classification exhaustively provides for the tabulation of operating revenues, operating expenses, and the ascertainment of net operating income, the respective

items are required to be returned for income tax according to, and the net income taxable to be ascertained with reference to, that classification of accounts. Section 202 contains the statutory method of ascertaining "net income" from the said standard classification of accounting.

It is against the classification contained in section 202 of the act that the appellants direct their contentions that the statute is discriminatory against interstate carriers and violates the 14th Amendment and the uniformity clause of the State Constitution.

Their argument in brief is: the Interstate Commerce Commission requires only railroads engaged in interstate commerce to keep the standard classification of accounts; section 202 provides a method of determining taxable net income for all railroad or other public-service corporations who are "required to keep records according to the standard classification of accounting of the Interstate Commerce Commission" different from the method of determining taxable income of railroads and other public-service corporations not required to keep such accounts; therefore it discriminates between corporations within the class of railroads and against those members of the class engaged in interstate commerce.

This we shall show is not the fact. All other railroads and public-service corporations of whatever kind are "required" by State authority to keep accounts according to the standard classification of accounting of the Interstate Commerce Commission and to return for income tax under the provisions of section 202 exactly as are the plaintiffs. Not only all railroads, domestic and foreign, interstate, connecting with interstate, and wholly intrastate, are taxed exactly alike and their taxable net incomes ascertained in the same way under the

method of section 202, but the same is true of all public-service corporations.

Contentions of the Railroads.

The contentions of the appellants upon which they lay the greatest stress are two:

First, that the tax is not a tax on net income, but is levied on gross income or on "net operating income," and hence is repugnant to the State Constitution and to the commerce clause of the Federal Constitution.

Second, that the classification made by section 202 of the act as to method of ascertainment of net income for the plaintiffs and other corporations within the designated class is arbitrary, without reasonable or practical basis, and hence is repugnant to the uniformity clause of the State Constitution and to the equal-protection clause of the Fourteenth Amendment.

Other minor complaints made against the tax are:

Third, that it is a violation of the State Constitution for the general property tax to be devoted to local purposes and the various excise, privilege, franchise, and license taxes and the income taxes to be devoted strictly to State purposes.

Fourth, that the income tax is invalid because it is levied in addition to property and franchise or privilege taxes.

Fifth, that the method of ascertaining their taxable income fixed by section 202 violates the uniformity clause of the State Constitution, or the Fourteenth Amendment, because it does not apply to those railroads or other public-service

corporations which do not operate their properties, but have income only from rentals paid them by other companies to which they lease their entire properties to be operated by the lessees.

Sixth, the Seaboard and the Atlantic Coast Line make the contention, not made by the other plaintiffs, that section 202 requires the plaintiffs to keep an accounting system in repugnance to power delegated by acts of Congress to the Interstate Commerce Commission.

Seventh, it is contended that the Income Tax Act is retroactive as to the months of January and February and as to eight days in March, 1921, because taxing the income for the whole year, and only ratified on the 8th of March, 1921.

Those seven contentions include all the points made by the appellants in their complaints in these suits. Two of them, the third and the fourth, have already been decided against them in the decision of the North Carolina Railroad Tax cases at this term. The remaining five we shall consider in this brief. Since these cases have been advanced together for argument, and since a motion for consolidation is pending, and the questions involved in the four suits are identical, we file but one brief of the appellees for the four appeals.

These appeals differ from those heard and decided by this court at this term and reported as *Southern Railway Company v. Watts*, in that the present appeals involve no attacks upon the administration of statutes, but raise only the constitutional question as to the validity of the Income Tax Act itself.

ARGUMENT.

I.

This is a tax on net income and not on gross income, and is therefore within the constitutional power of the State and repugnant neither to the State Constitution nor to the commerce clause of the Federal Constitution.

1. A Tax on Net Income of an Interstate Carrier is Valid.

The first contention of the appellants is that under the income-tax clause of the State Constitution and under the commerce clause of the Federal Constitution the State is limited to taxing net incomes, and that the tax here in question is not in truth a tax on net income but on gross income or on net operating revenue (which they contend includes some gross income), and hence repugnant to both constitutional provisions.

The basis for this contention is the same as that for the contention that the statute makes an arbitrary classification, is discriminatory, and violates the Uniformity Clause of the State Constitution and the 14th Amendment of the Federal Constitution—the fact that under the provisions of section 202 the taxable net income of corporations to which that section applies is ascertained without allowing deduction of interest on bonded indebtedness and of rentals paid on long-term leases, whereas other taxpayers in general are allowed deduction of interest paid and of business rentals.

We shall consider these distinctions in the method of ascertaining taxable net income more in detail when we come

to the discussion of the contention as to discrimination. For the present we shall consider them only in so far as they bear upon the question whether this tax on railroads is a tax on net income in a constitutional sense.

It is so well settled as to be no longer the subject of discussion that it is within the constitutional power of a State to levy an income tax on the net incomes earned within the State of persons and corporations engaged in interstate commerce, and that such a tax is not a burden on interstate commerce and does not violate the commerce clause, although the net incomes taxed may be derived in part or mainly from the business of interstate commerce.

U. S. Glue Co. v. Oak Creek, 247 U. S., 321;

Shaffer v. Carter, 252 U. S., 37, 57;

Travis v. Yale and Towne Mfg. Co., 252 U. S., 60, 75;

Underwood Typewriter Co. v. Chamberlain, 254 U. S., 113.

The constitutional distinction between such a tax and a tax on the whole volume of business or on the gross income or revenue of one engaged in interstate commerce, which is held to be a burden on interstate commerce and a violation of the commerce clause, is clear.

Compare *Crew Levick Co. v. Pennsylvania*, 245 U. S., 292, and cases there cited.

An exact analogy is to be observed in the restriction imposed upon Congress by article I, section 9, clause 5, of the Constitution, "No tax or duty shall be laid on articles exported from any State." Under that clause it is held upon exactly the same reasoning that a tax by Congress measured

by gross revenues from the business of exportation is a direct burden on such business, and hence is a tax on exports and invalid, but that a tax on net incomes from such business is no more than an indirect burden thereon and is therefore not a tax on exports and is valid.

Peck & Co. v. Lowe, Collector, 247 U. S., 165.

Even if the Constitution of North Carolina in the income-tax clause limits the Legislature to a tax no more onerous than a tax on net income, still that limitation would be exactly coextensive with the limitation of the commerce clause of the Federal Constitution. If, therefore, the tax here in question is a tax on net income within the meaning of the limitation imposed by the commerce clause, it cannot be successfully attacked as not being a tax on net income under the State Constitution.

2. What is "Net Income?" *Legislative Power of Definition.*

The pertinent provision of the State Constitution is:

"The General Assembly may also tax * * * incomes: *Provided*, the rate of tax on incomes shall not in any case exceed six per cent (6%), and there shall be allowed the following exemptions, to be deducted from the amount of annual exemptions, to wit: for a married man with wife living with him, or to a widow or widower having minor child or children, natural, or adopted, not less than \$2,000; to all other persons not less than \$1,000, and there may be allowed other deductions (not including living expenses), so that only net incomes are taxed."

This is couched in the language of a non-self-executing, as contrasted with a self-executing, constitutional provision. The language is purely permissive. The General Assembly may, or may not, as it sees fit, impose the tax. It is in direct contrast with the requirement as to property tax, which is mandatory: "Laws *shall be passed* taxing by a uniform rule all moneys," etc. The permissive provision as to income taxation is not self-executing.

The distinction between the two kinds of constitutional provision is pointed out by the Supreme Court of North Carolina in the case of *Kitchen v. Wood*, 154 N. C., 565, wherein it is said:

"We have reached the conclusion that section 1, article V of the Constitution of this State, is mandatory, self-executing and leaves nothing to the discretion of the lawmaking power.

"Its plain mandate is that the General Assembly 'shall levy a capitation tax on every male inhabitant of the State, which shall be equal to the tax on property valued at \$300 in cash.'

"As said by the Attorney General, 'In the execution of this command, the General Assembly acts in a purely ministerial capacity. Its function is executive and not legislative. It is made the agent, the accountant, of the Constitution, with directions to make a calculation and record it.' * * *

"As to whether a particular constitutional provision is self-executing seems to be one of intention to be gathered from the instrument itself and determined by the language used and the purpose intended to be carried out.

"The provision in our organic law is complete in itself, needs no legislation to give it effect, and no

special means for its enforcement. Provisions of that character are regarded as self-executing. *Groves v. Slaughter*, 15 Peters (U. S.), 449; *Davis v. Burke*, 179 U. S., 399; *Newport News v. Woodard*, 7 Am. and Eng. Anno. Cases, 627, and cases cited in notes."

Under this rule, of course, the income-tax provision of the State Constitution is not mandatory, is not complete in itself, does leave something to legislative discretion, and does need legislation to give it effect. The act of the Legislature in passing an income-tax statute pursuant to this permissive provision is, therefore, a sovereign legislative act, not an executive or ministerial one. It is clearly within the competency of the Legislature to define "income" or "net income," to prescribe what deductions shall be allowed from gross income, so that net income only shall be taxed. This discretion is expressly left to it. And it is within the discretion of the Legislature to fix the rate of the tax.

The State Constitution merely uses the term "net income." It does not define it. Is it a term which needs definition, which is susceptible of definition? If so, what power shall make that definition if it be not the Legislature?

The term "net income" is not so definite in its significance as, by its own force, to set apart that portion of one's earnings which shall constitute, without further legislation, "net income."

Here are the definitions of "net income" to be found in the books:

Bouvier's Law Dictionary:

"The excess of the gross earnings over the expenditures defrayed in producing them, aside from, and exclusive of, the expenditure of capital laid out in

constructing and equipping the works themselves. *Union Pacific R. Co. v. United States*, 99 U. S., 420. See *Barry v. Railroad Co.*, 27 Fed., 1; *St. John v. Railroad Co.*, 22 Wall. (U. S.), 148; *Sioux City R. R. Co. v. United States*, 110 U. S., 205."

29 Cyc., 671:

"Of a business or corporation, the products of a business, deducting the expenses only."

In the case of *American Loan & Trust Co. v. East, etc., R. Co.*, 36 Fed., 101, 102, "net income" was construed as meaning "all over and above operating expenses."

In the case of *Kansas City So. Ry. v. United States*, 231 U. S., at 445, the Supreme Court gave the very same definition of "net earnings" as that given by Bouvier for "net income," wherein it was said, quoting from *Union Pacific R. Co. v. United States*, 99 U. S., 402:

"As a general proposition, net earnings are the excess of the gross earnings over the expenditures defrayed in producing them aside from, and exclusive of, the expenditure of capital laid out in constructing and equipping the works themselves. It may often be difficult to draw a precise line between expenditures for construction and the ordinary expenses incident to operating and maintaining the road and works of a railroad company."

That quotation from this court's decision points out the very indefiniteness of meaning of the expression net income or net earnings, the very necessity for definition of such expression which has given rise to these suits. It is impossible to draw an accurate, theoretical, and precisely technical line

of demarcation between what are capital expenditures, laid out in constructing and equipping the works themselves, on the one hand, and the mere ordinary expenses incident to operating and maintaining the road and works of a railroad on the other.

The appellants contend that the interest which they pay on their bonded indebtedness and the rentals which they pay on 99-year leases of subsidiary railroads are current business expenses, the mere ordinary expenses incident to operating and maintaining their roads and works. The appellees contend that they are capital expenditures, laid out in constructing and equipping the works themselves; that railroads are largely financed by their bonds, that their long term leases of subsidiary roads amount practically to purchases, entirely distinguishable from current rentals paid by an ordinary business corporation for its place of business (see affidavit of A. J. Maxwell, A. C. L. Record, pp. 57-59), and that net income is arrived at without allowing these deductions.

Both contentions may savor of the technical, the hypercritical. They show, however, that very difficulty which this court pointed out in the *Kansas City So. Ry. Case, supra*, of drawing the precise line.

The appellants here ask the court to adopt their technical definition of "net income" and to strike down the revenue statute of North Carolina because its definition does not correspond to theirs. That is exactly the sort of thing which the court refused to do in the case just cited.

In that case it was held that, by reason of this difficulty in arriving at an exact judicial definition of "net earnings," it was competent for the Interstate Commerce Commission,

under the general authority given it by Congress to require systems of accounts, to provide what particular items should be included in expenses, and deductions allowed, in order to arrive at net earnings.

The same sort of contention was made in this court as to the corporation tax of 1909, 36 Stat., 112, in the case of *Anderson v. Forty-two Broadway Company*, 239 U. S., 69.

The statute imposed a special excise tax equivalent to one per centum upon the entire net income over and above five thousand dollars. It defined "net income" by authorizing deductions from gross income, among other things, of "interest actually paid within the year on its bonded or other indebtedness to an amount of such bonded or other indebtedness not exceeding the paid-up capital stock of such corporation." A realty company in New York had only \$600 of capital stock and a bonded indebtedness of \$1,750,000 secured by mortgages on real estate.

The taxpayer contended and the district court and the circuit court of appeals held that it should be allowed to deduct interest paid on this bonded indebtedness in arriving at "net income," in view of another provision of the statute which permitted deduction of "all the ordinary and necessary expenses actually paid within the year out of income in the maintenance and operation of its business and properties, including all charges such as rentals or franchise payments, required to be made as a condition to the continued use or possession of property," and in view of its contention that if this deduction be not allowed its tax would not in truth be measured by a percentage of its net income.

This court dismissed that contention with these words:

"With these views we cannot agree. There was error, as it seems to us, in seeking a theoretically accurate definition of 'net income,' instead of adopting the meaning which is so clearly defined in the act itself."

And the same contention was again made here by a taxpayer attacking the Federal Income Tax law of 1913 in its application to mining corporations in the case of *Stanton v. Baltic Mining Company*, 240 U. S., 103.

The mining company there contended that by reason of the differences in the allowances which the statute permitted the tax levied was virtually a net income tax on other corporations and individuals and a gross-income tax on mining corporations (p. 111), and the court said, as to that and many other similar contentions:

"But it is apparent from the mere statement of these contentions that each and all of them were adversely disposed of by the decision in the *Brushaber* case (240 U. S., 1), and they all therefore may be put out of view."

In the same way it has been held by the Supreme Court of North Carolina that since the Constitution did not define "petty misdemeanors," and since there was no well-defined line of demarcation when that instrument was adopted, it is competent for the General Assembly to define and mark out the offenses which shall be so classified.

State v. Lytle, 138 N. C., 738;

See, also, *State v. Collins*, 151 N. C., 648.

Again, section 6 of article VI of the State Constitution is as follows: "All elections by the people shall be by ballot,

and all elections by the General Assembly shall be *viva voce*." It was held, under this section, that while "ballot" means a written or printed expression of the will of the voter, the Legislature has the discretion to prescribe the size, form, and character of the ballots to be used, and that the constitutional provision does not prevent it from regulating the conduct of the elector and the officers at the polls.

DeLoatch v. Rogers, 87 N. C., 358;

Baxter v. Ellis, 111 N. C., 124;

Slaymaker v. Phillips, 5 Wyo., 453; 47 L. R. A., 842.

In the case of *Jenkins v. Board of Elections*, 180 N. C., 169, the court held that the terms "offer to vote" in article VI of the Constitution do not have such a well-defined meaning as to prevent the Legislature from defining them as not requiring the personal presence of the voter at the polls at the time he votes. See, also, *State v. Nevada Central R. Co.*, 113 A. S. R., 834, and *New York v. Manhattan R. Co.*, 192 N. Y. S., 90.

In *State v. Webb*, 155 N. C., 426, it was held that the word "speedy" in the provision of the Constitution requiring speedy trials of persons charged with crime is of indeterminate meaning, permitting legislative definition.

It seems, therefore, perfectly clear that the expression "net income," as used in the State Constitution and as used in the decisions of this court under the commerce clause, is not an expression of exact technical meaning; that judicial definitions of it are always in general terms, and that it is within the competency of the Legislature of the State to define its meaning.

3. *The Definition of "Net Income" in This Statute. What North Carolina Taxes as to the Plaintiffs.*

Let us see what North Carolina seeks to tax as to each of the plaintiffs. The facts are the same as to all and they may be considered together. They are all interstate carriers engaged in business partly within and partly without this State. The net income for taxation of each is ascertained in the same way under section 202, the pertinent and essential parts of which read as follows:

"The basis of ascertaining the net income of (the plaintiffs) * * * shall be * * * their net income within this State shall be ascertained by taking their gross 'operating revenues' within the State, including * * * the equal mileage proportion within this State of their interstate business and deducting from their gross 'operating revenues' (so ascertained) the proportionate average of 'operating expenses,' or 'operating ratio,' for their whole business, as shown by the Interstate Commerce Commission Standard Classification of Accounts."

Following the mathematical operation thus far outlined by the statute leads to a result which the statute calls the "net operating income" of the taxpayer. *It is not this which is taxed, however*, although all of the operating expenses allowed by the Interstate Commerce Commission to be included in that term have already been deducted from gross revenues. The statute proceeds to authorize other specific deductions from this so-called "net operating income" in order to produce the resulting taxable *net income*. It continues:

"From the net operating income thus ascertained shall be deducted 'uncollectible revenue' (in other words, losses or bad debts) and taxes paid in this State for the income year, other than income taxes and war profits and excess-profits taxes, and the balances shall be determined to be their net income taxable under this act."

In addition, chapter 35, Public Laws of 1921, amended section 202 so as to decrease or to charge to increase net income as so found, any debit paid or any credit received by the railroad for car hire. The full text of this amendment is printed in the margin.¹

To understand, then, what has actually been allowed to the plaintiffs as deductions from their gross revenues earned in North Carolina, we must look to the standard classification of accounts of the Interstate Commerce Commission to see what that classification includes in the term "operating expenses" or "operating ratio," all of the items of which are allowed to the plaintiffs as deductions.

The plaintiffs have filed affidavits in these suits, attaching as exhibits the regulations of the Commerce Commission as to standard classification of accounts, and we pray the court to make reference to these exhibits to see the extreme com-

¹ "SEC. 1. That in determining the taxable income of a corporation engaged in the business of operating a railroad under section two hundred and two of the act to raise revenue, in the case of a railroad located entirely within this State, the net operating income shall be increased or decreased to the extent of any credit or debit balance received or paid, as the case may be, on account of car hire; and when any railroad is located partly within and partly without this State, then said net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid, as the case may be, on account of car hire."

pleteness of detail with which every conceivable expense is included. (See affidavit of J. C. Nelms, Jr., and attached exhibits, Atlantic Coast Line Record, pp. 67-82.)

Many expenses are included which are not allowed as deductions under the Income Tax Law of North Carolina to any other taxpayers or class of taxpayers than those required to keep this standard classification of accounts, a few of the more important of which are: purchase of tools and small equipment, which are allowed as expenses to railroads under this classification, but which are considered as capital invested in the case of other taxpayers; the extremely important item of money paid out by the railroad upon judgments, but which is not allowed other taxpayers than public-service corporations keeping the standard classification of accounts; and all amounts paid out as premiums for insurance of all kinds—fire, storm, liability, and casualty. A general summary of these items included in the standard classification of "operating expenses" or "operating ratio" has been attached to the answers in these suits, and space forbids even such general summary here. (See A. C. L. Record, pp. 30-31.) Reference is made to the standard classification itself in the regulations of the Commission.

It needs only a glance at section 202 of the act and at the standard classification of accounts to find the refutation of the contention of the railroads that while other taxpayers are taxed on their net incomes the railroads are taxed on "net operating revenue" or "net operating income."

The first item of the calculation in arriving at the taxable net income of the appellant railroads is "gross operating revenue" within the State according to the standard classification, including the mileage proportion attributable to

North Carolina of interstate business. This item is not taxed, but from it are deducted all those multitudinous items included in the standard classification as "operating expenses" or "operating ratio." The result of this subtraction is the second item of the calculation called by the statute "net operating income." It is not taxed, as appellants seem to contend, but from it are in turn deducted uncollectible revenues and taxes. The final result is, in express terms and in fact, NET INCOME, and it is that net income which is taxed.

4. *This is a Tax on Net Income and Therefore Valid.*

We have seen what the statute taxes with reference to all taxpayers included within the scope of section 202; the legislative definition of what taxable "net income" shall be as to those taxpayers.

We submit that this definition contained in the statute is strictly in conformity with the definitions of "net income" or "net earnings" in judicial opinions and particularly in the opinions in the cases of *Union Pacific R. Co. v. United States*, 99 U. S., 402, and of *Kansas City So. R. Co. v. United States*, 231 U. S., at 455.

This statutory definition allows to the plaintiffs deductions of all operating expenses, all expenses incurred in the business of earning the gross revenues and adjusts their losses. The tax is imposed, not on gross revenues, still in the business, before the deduction of expenses and the adjustment of losses, but is imposed purely on the net income apportionable to North Carolina, after that income has been separated from the general business operations of the plaintiffs by deduction of the expenses of producing the revenue and of the

losses incurred in its production. The imposition is, therefore, not a direct burden on interstate commerce, but is, at most, only an indirect burden, not prohibited by the commerce clause, but strictly within the distinction made in the cases of *Crew Levick Co. v. Pennsylvania*, 245 U. S., 292, on the one hand, and of *Peck & Co. v. Lowe*, 247 U. S., 165; *U. S. Glue Co. v. Oak Creek*, 247 U. S., 321; *Underwood Typewriter Co. v. Chamberlain*, 254 U. S., 113, and others, on the other.

Why do the appellants contend that it is not in fact and in law a tax on net income?

The first reason they give is that the Interstate Commerce Commission has given a different definition of "net income" for its rate-making purposes. In the district court it was squarely argued by the railroads, and we assume will be argued here, that the Legislature of North Carolina had not the power to make the definition of "net income" made by section 202 of the statute, because the Interstate Commerce Commission has made a different definition for rate-making purposes.

We know of no principle or authority to the effect that such a definition by the Federal administrative commission, in pursuance of its rate-fixing function, should have any binding or controlling force to preclude the Legislature of a State from making a different definition, in pursuance of its sovereign taxing power, and the appellants have cited us to none.

The only authority we have seen cited to this proposition is the case of *Stratton's Independence v. Howbert*, 231 U. S., 399, which is asserted to contain a definition of "net income" at variance with that made by the Legislature of North

Carolina. The opinion in that case contains nothing whatever in the way of a definition of net income. It does define income as being "the gain derived from capital, from labor, or from both combined." And this, we take it, is the well-recognized definition of income. It contains nothing which helps the contention of the appellants.

The appellants point out that under the standard classification of accounting of the Interstate Commerce Commission there are two classes of accounts as to revenues and expenses: (1) Operating revenues and operating expenses accounts; and, (2) income, profit and loss, and general balance-sheet accounts.

The accounts of the first class include only revenues proceeding from and expenses incident to the actual business for which a railroad is created, transportation in commerce. The accounts of the second class include other sources of revenue not included in those of the first class and include all expenditures, whether capital expenditures or current business expenditures, and the result of those accounts is to strike a balance of all revenues and all expenses and arrive at a "net balance of income (or loss)" which shall be carried to "profit and loss." (See brief of Norfolk Southern, pages 13 to 16.)

They contend that it is this "net balance of income," this profit, which the State should tax as their net income, and that this statute is unconstitutional because it disregards all income except that derived from the main business for which the taxpayer is organized and fails to allow as deductions corresponding expenses which are not current business expenses incident to that main business.

There have been some theorists who have argued that the

wisest and fairest, if not the most productive, tax would be a tax which allows the taxpayer at the end of the year to strike an absolute balance of all income and of all outgo and to be taxed solely on the net profit or savings which he could put away after all of his expenditures had been settled. That sort of tax would tax railroads on the "net balance of income" carried to "profit and loss" as shown in the "income, profit and loss, and general balance sheet accounts" of the standard classification. That sort of tax would tax an individual only on that net profit or saving which he is able to put in the savings bank at the end of the year after the payment of all of his personal and family living expenses and all debts due and payable.

But, so far as we are informed, such a tax has never yet been adopted by any State or nation. It is certain that the fact that an income tax is not such a tax does not render it unconstitutional and does not mean that it is not a tax on net income. If that did follow, neither the Federal income tax nor any State income tax would be a tax on net income.

Passing, then, from their argument that the Interstate Commerce Commission has taken this power of definition away from the Legislature of North Carolina, the appellants squarely contend that this tax is a direct burden on interstate commerce as being a tax on gross income instead of on net income, because it does not allow to those taxed under section 202 deduction of interest paid on funded and unfunded debt, interest paid on bonds.

This court has often said that it cannot close its eyes to well-known facts, and that it will take judicial notice of matters of common knowledge and of current and public

history. We think it will take judicial notice of the fact that the greatest part of the capital assets of railroads is raised by bond issues. The defendants below introduced evidence to this effect at the final hearing. (See affidavit of A. J. Maxwell, Atlantic Coast Line Record, pp. 57 to 59.)

Although railroads do have common and preferred stock it is usually of low market value and frequently earns no dividends. Railroads are built and financed by bond issues. As to them, therefore, their bond issues are analogous to the stock of ordinary corporations, particularly the preferred stock. No corporations are allowed deductions of dividends paid on preferred stock, as interest, under the North Carolina Income Tax Act (section 306, subsection 3).

It was precisely the same line of reasoning as that contained in the affidavit of Mr. Maxwell which caused the Congress to place the limit on the Corporation Tax Act of 1909 as to the extent to which interest on bonded indebtedness could be allowed as a deduction. When, in the case of *Anderson v. Forty-two Broadway Company*, 239 U. S., 69, which we referred to above, the taxpayer made the same argument these railroads are now making, that interest on bonded indebtedness must be allowed as a deduction, otherwise the tax would not in fact be a tax on net income, this court answered that contention by the same reasoning as that in Mr. Maxwell's affidavit. It said:

"It is not necessary to attribute to Congress a purpose to discourage or impose an extra burden upon corporations carrying on their operations with a nominal capital stock, or with an indebtedness largely exceeding the amount of the capital. It is more reasonable to say that Congress deemed that where the

indebtedness does exceed the capital it should no longer be treated as an incident, but that the carrying of the indebtedness should be considered as a principal object of the corporate activities, that the operations of such a corporation are conducted more for the benefit of the creditors (bondholders) than of the stockholders, and that the contribution of the corporation to the expenses of the Government should be admeasured with this fact in view. There is no question of the power of Congress to adopt such a basis of distinction, and, since the line must be drawn somewhere, it was certainly not arbitrary to draw it at the precise point where the pecuniary interest of creditors overbalanced that of stockholders."

In other words, under the definitions of net income above quoted, it is gross income, less only the expenses and losses incurred in earning that income, not less any expenditure for capital, capital assets, or permanent equipment. Interest on bonded indebtedness is a *capital expense*, and incident to the creation of the capital and capital assets of the corporation. It is not an operating expense incident to the business of earning the revenue. There is no logical reason why it should be allowed as a deduction.

The plaintiffs complain that individuals and other corporations are allowed to deduct interest on indebtedness, and that they are not. They do not see that the difference is that the interest they wish to deduct is interest on capital indebtedness, while that which individuals and other corporations are allowed to deduct is interest on current business indebtedness expended in the operations of the business. Other corporations are allowed no deduction for the dividends on preferred stock which correspond to the railroad's interest on bonds.

Again, the appellants complain that other business corporations are allowed to deduct rentals and that they are not allowed deductions for rentals paid by them for the lease of other railroad lines operated by them. We answer this contention in the words of Mr. Maxwell in his affidavit (*Atlantic Coast Line, Record, p. 58*):

“With reference to the matters of rentals paid for the lines leased and operated by the railroads, the committee considered the well-known facts that these leases are usually for long terms and with numerous collateral obligations which make them amount practically to purchases of the lessor road's properties by the lessee, and that, this being true, the consideration paid for such long leases of property used fully as if the property of the lessee in its business is really not an operating expense but is by clear analogy and in practical effect a capital expense. If these expenses were allowed as deductions to the plaintiffs, the result would be that they would have no income subject to tax until they had earned enough to provide, not only for all business and operating expenses, but also for all capital expenses and had paid all interest on their bonds; in other words, it would amount to nothing more than a tax on the savings of railroads, which would render the tax utterly incommensurate with that imposed as income tax on individuals and other ordinary corporations.”

The distinction between the rentals paid on these long 99-year leases and rentals paid by an ordinary business corporation for offices and a place in which to do business is manifest. It is again the logical distinction between capital expenses and operating or business expenses. The lessee railroad is, under the covenants contained in these leases, prac-

tically the owner of the leased line for the period during which the lease is to run. The rentals paid by it are capital expenses or capital investment, and not operating expenses. In this the Interstate Commerce Commission agrees with the contentions of this brief, for such rentals are not included as operating expenses in its standard classification of accounts.

Remembering that this question as to whether the income tax here considered is a tax on net income or on gross income is a question of power and not of propriety, we reply to all arguments of the appellants as to the propriety or wisdom of allowing deduction of these items of interest and rentals by the following language of this court from the opinion in the case of *Brushaber v. Union Pacific R.*, 240 U. S., 1, 25:

"In this situation it is of course superfluous to say that arguments as to the expediency of levying such taxes or of the economic mistake involved in their imposition are beyond judicial cognizance."

We think we have demonstrated the propriety of the Legislature's definition of net income as to taxpayers taxed under the provisions of section 202 of the statute. We are confident, however, that there can be no doubt as to its power to make that definition.

We conclude that the Income Tax Act of 1921 imposes on the plaintiffs a tax on net income within the ordinary meaning of the term and within the definition of such tax given by all the authorities binding upon this court; that such tax is in no way inhibited, but, on the contrary, is specifically authorized by the Constitution of North Carolina; that under the well-defined rule of the Supreme Court of the United States this tax is not a direct burden on interstate commerce,

although the net income taxed may proceed largely from interstate commerce, and in no way violates the commerce clause; that it is repugnant, therefore, neither to the Constitution of the State nor to the Constitution of the United States.

II.

The classification of which the appellants complain is upon a practicable and reasonable basis and is no such arbitrary discrimination as is prohibited by either the uniformity clause of the State Constitution or the Fourteenth Amendment.

1. The Contentions of the Appellants as to Classification.

It would be useless for us to review the decisions of this court in which it has passed upon the validity of taxing and other statutes of States, attacked upon allegations of discrimination and repugnancy of classification to State uniformity provisions and to the Fourteenth Amendment.

We shall concern ourselves with the statute and the matters in the records in these suits and with an attempt to demonstrate that the classification of the statute in question is perfectly competent under the well-settled principles enunciated by this court in the cases of *Bell's Gap R. Co. v. Pennsylvania*, 131 U. S., 237; *Magoun v. Illinois Trust & Savings Bank*, 170 U. S., 283, and the many subsequent cases, as recent as *Dane v. Jackson*, 256 U. S., 589, *Heisler v. Thomas Colliery Co.*, No. 541 this term, decided November 27, 1922, and *Southern Railway Company v. Watts*, No. 368 this term, decided January 2, 1923.

The contention of the appellants is that for the statute to make a class of "every corporation engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the standard classification of accounting of the Interstate Commerce Commission," and to provide that the taxable net income of members of that class shall be ascertained by a rule of calculation different from that provided with respect to taxpayers not of that class, is arbitrary classification, discrimination, and violates the uniformity provision of the State Constitution and the Fourteenth Amendment.

It would seem that the mere statement of this proposition is its own sufficient answer.

Even had that classification effected by the statute been much narrower than it is and had it included only railroad corporations, it is so well settled as to be no longer the subject of discussion that the classification of railroad corporations together is valid classification, that it is perfectly competent for a State, both under its own uniformity rule and under the Fourteenth Amendment, to provide a different method of taxing railroads from that provided for taxing other corporations and other individuals.

State Railroad Tax Cases, 92 U. S., 575;

Kentucky Railroad Tax Cases, 115 U. S., 321, 337;

Missouri v. Lewis, 101 U. S., 22;

Missouri Pacific R. Co. v. Mackey, 127 U. S., 205;

Minneapolis, etc., R. Co. v. Beckwith, 129 U. S., 26;

Bell's Gap R. Co. v. Pennsylvania, 134 U. S., 232;

Pacific Express Co. v. Seibert, 142 U. S., 339.

For the double reasons that it is not a fact and that if it were it would constitute no unconstitutionality in the statute, therefore, we do not expect the appellants to press here the contention argued by them in the district court, that the statute in question is invalid as putting railroad corporations in one class and taxing them by a different rule from all other taxpayers.

The appellants go a step farther, however, and contend that the statute makes an arbitrary classification even within the general class of railroad corporations, in that it bases the classification as to those who are taxed under the provisions of section 202 on the question whether they are "required to keep records according to the standard classification of accounting of the Interstate Commerce Commission." And they assert that this is not a reasonable basis of classification. They argue that only railroads engaged in interstate commerce are "required" (by the Interstate Commerce Commission) to keep the standard classification of accounting and that the statute therefore in effect enacts a hostile discrimination against corporations engaged in interstate commerce.

These contentions make it necessary to examine with care the question of what taxpayers are actually included within the provisions of section 202.

2. The Classification Actually Made by the Statute and Laws of North Carolina.

Section 202 of the statute does not limit the scope of its provisions to corporations of the classes designated which are "required by the Interstate Commerce Commission" to keep the standard classification of accounts. It merely creates

a class of those "required" to keep their accounts according to that classification of accounts.

They may be "required" by either Federal or State law, by rule of the Interstate Commerce Commission, or of the revenue department of the State.

The fact is, as shown by the records in these appeals, that not only railroads engaged in interstate commerce, but all railroads doing business as common carriers in North Carolina, all electric railroads, express companies, telephone or telegraph companies, and all public-service corporations of whatever kind, are taxed exactly alike under the Income Tax Act of 1921 and are required to make return of their taxable net income under the provisions of section 202 of this act and to calculate their taxable net income in the same way and with only the same deductions as the appellants in this cause. There is no basis in fact for the contention that there is a discrimination against carriers engaged in interstate commerce.

The records show (Atlantic Coast Line, Record, pp. 54 to 56) that the State department of revenue has only one blank for returns of income tax which is sent out to and used by all railroads engaged in the operation of railroads. This is form 7, a copy of which was attached to the affidavit of O. S. Thompson (Record cit., 54), but was by mistake not printed in the record in connection with that affidavit. A copy of that form is attached to this brief as Appendix A. As shown by that affidavit, this form is required by the State department of revenue to be filled out by all railroads doing business in North Carolina, whether operating wholly within the State or both within and without, whether operating wholly within the State, but as connecting carriers with in-

terstate railroads, or whether doing a purely intrastate business.

This form and the rules of the department of revenue require report by all such railroad corporations of their net income as defined by and calculated according to the provisions of section 202 of the statute and based upon and according to the standard classification of accounts of the Interstate Commerce Commission.

And the affidavit says further:

"Affiant states, therefore, as a matter of his own knowledge, that the Income Tax Act of 1921, as administered by the State department of revenue, applies exactly in the same way and without any discrimination whatsoever to all railroad corporations doing any business in the State engaged in railroad operation, whether foreign or domestic, whether operating partly within and partly without the State, or wholly within the State. All are required to make return for income tax according to the standard classification of accounts and under section 202, and *exactly the same deductions are allowed to all, without discrimination.*"

The records further show (Atlantic Coast Line Record, p. 56, where a line is omitted in the printing, *compare* Southern Record, p. 31, bottom, which is printed correctly) that not only is the entire class of railroads engaged in the railroad business subjected to income taxation under the provisions of section 202, but that the same is true as to the far broader class of all strictly public-service corporations.

The State department of revenue has only one form for income tax return for all public-service corporations other

than railroads, form 8, a copy of which was attached to the affidavit of Thompson (Record cit.) but by error has been omitted from the printed records and which is attached to this brief as Appendix B. So that the department of revenue requires not only of all railroads engaged in railroading, but of all public-service corporations, that they file returns for income tax upon the basis of the standard classification of accounts under the provisions of section 202. As to all of those corporations taxable net income is ascertained in exactly the same way and the same deductions only are allowed.

The plaintiffs below, however, found two lumber companies which have constructed short lumber railroads for the prosecution of their lumber business and transportation of their lumber products to connecting common carriers and secured from them affidavits to the effect that they were not taxed under the provisions of section 202, but were allowed and entitled to be allowed under the law the deductions allowed to private corporations not engaged in public service (Atlantic Coast Line Record, pp. 25 to 28).

They then argued that here were two "railroads" which were not included in the statutory classification of railroads, and which were taxed not as railroads and public-service corporations, but as ordinary private business corporations. This is the basis of their contention that they are discriminated against because they are engaged in interstate commerce.

We think that such a contention would not merit attention here except for the fact that it is the final resting place upon which the appellants must place their contention of invalidity of the statute.

Of course these lumber companies are not railroads. Their little lumber roads are operated as a pure incident to their main business of manufacturing and selling lumber. They are not even allowed to transport commodities of others except to a limited degree, and they are classed by the State Corporation Commission (the public utilities commission) as "limited common carriers." They are not classed as railroads at all. They are allowed to enter into even this limited carrier business merely as an accommodation to the surrounding farmers, and they undertook such business for such purpose at a loss and as a patriotic duty during the war (Atlantic Coast Line Record, pp. 35 to 37).

It would call for much subtlety and an extreme technical refinement to apply the name of "railroads" to these lumber companies. But to ask this court to hold unconstitutional a State tax statute because it puts into one class all railroads and excepts these lumber roads from that class is a proposition which we do not think will bear examination.

As a last effort, however, to find some loophole in the classification created by the statute and laws of North Carolina and to show that there was at least one "public-service corporation" to be found which was not taxed like the appellants under section 202, the plaintiffs below introduced the affidavit of J. H. Bridgers (A. C. L. Record, pp. 33 to 47) who swore that he was president of the Henderson Water Company, and that his corporation was not required to keep its accounts according to the standard classification of the Interstate Commerce Commission and was not taxed under the provisions of section 202.

The result was that the tax clerk of the State department of revenue swore that Mr. Bridgers' company's return, to-

gether with returns of other corporations, had not yet been checked for correctness, but that if it was made as stated in Mr. Bridgers' affidavit it would have to be made again, and that his water company would most certainly be taxed under the provisions of section 202 of the act and would be allowed only those deductions in calculating taxable net income allowed to the plaintiff railroads (A. C. L. Record, p. 56).

3. *The Classification Made by the Statute is Perfectly Reasonable and Valid.*

The question always is, when a classification is made, whether there is any reasonable grounds for it, or whether it is purely and simply arbitrary, based upon no real distinction, and entirely unnatural. If the classification be proper and legal within this rule, then there is the requisite uniformity.

Gulf, etc., R. Co., v. Ellis, 165 U. S., 150;

Magoun v. Illinois Trust & Savings Bank, 170 U. S., 283;

Nichol v. Ames, 173 U. S., 509.

It is not only competent to make a separate class of all railroads, but it is competent for the Legislature to make classification within the general class of railroads. Thus it may make a separate class for taxation of only those railroad corporations using city streets.

Savannah, etc., R. Co. v. Savannah, 198 U. S., 392.

And it may make separate classes, distinguishing between surface railroads and sub-surface railroads.

New York v. N. Y. Tax Commissioners, 199 U. S., 53.

The equal-protection clause of the Fourteenth Amendment was not intended to prevent a State from adjusting its system of taxation in all proper and reasonable ways. It may, if it chooses, exempt certain classes of property from any taxation at all, such as churches, libraries, and the property of charitable institutions. It may impose different specific taxes upon different trades and professions and may vary the rates of excise upon various products; it may tax real estate and personal property in a different manner; it may tax visible property only and not tax securities for the payment of money; *it may allow deductions for indebtedness or not allow them.* All such regulations, and those of like character, so long as they proceed within reasonable limits and general usage, are within the discretion of the State Legislature, or the people of the State in framing their constitution.

Bell's Gap R. Co. v. Pennsylvania, 134 U. S., 232, 237;

Pacific Express Co. v. Seibert, 142 U. S., 339;

Adams Express Co. v. Ohio, 165 U. S., 194.

Railroad companies are not discriminated against contrary to the equal protection clause of the Fourteenth Amendment by imposition upon them of an excise tax when other public utilities are not so taxed.

Ohio Tax Cases, 232 U. S., 576.

See also generally *Bickett v. Tax Commission*, 177 N. C., 433, and cases there cited.

A discrimination between corporations and individuals with regard to taxation cannot be pronounced arbitrary, al-

though the court may not know the precise ground of policy that led the State to insert the distinction in the law. The State may have a policy in taxation, and the courts may not review that policy.

Quong Wing v. Kirkendall, 223 U. S., 59, 63;

Ft. Smith Lumber Co. v. Arkansas, 251 U. S., 532.

We see at once that no contention of such discrimination in the Income Tax Act of 1921 as would violate either the State uniformity rule or the equal-protection clause of the Fourteenth Amendment can be maintained, because, as we have shown, all railroads are classed together and taxed exactly alike upon their incomes by North Carolina. All are taxed under the provisions of section 202. All make return for income tax on the same blank, form 7, Exhibit A to this brief. The taxable net income of all is ascertained from the items prescribed by the standard classification of accounts of the Interstate Commerce Commission.

It is beyond dispute that it is perfectly valid for the State to tax railroads alike in one class, and other corporations and individuals differently in other classes.

But the classification is even broader and more general than this. As we have seen, it not only includes railroads, but it includes all other public-service corporations. They all make return for income tax on the substantially similar form 8, Appendix B, according to the standard classification of accounts of the Interstate Commerce Commission, and they are also taxed under the provisions of section 202.

Here is classification of such broad and inclusive scope as creates a much greater uniformity and gives a far more equal protection of the laws even than is required by the State and Federal Constitutions. This classification is unassailable.

A glance at the cases cited by the plaintiffs as sustaining their contention that this tax violates the Fourteenth Amendment is sufficient to show the clear distinction between each of those cases and ours. They are:

Royster Guano Co. v. Virginia, 253 U. S., 412;
Gulf, etc., R. Co. v. Ellis, 165 U. S., 150;
Cotting v. Kansas City Stock Yards, 183 U. S., 79;
Connolly v. Union Sewer Pipe Co., 184 U. S., 540.

In the *Royster Guano Co. case*, *supra*, there was no question of differences in method of ascertaining the net income of various classes of taxpayers, as in our case, but the question was the direct one, whether it was competent for the State to tax a certain class of income of certain domestic corporations and leave untaxed the same class of income as to other domestic corporations. Our case shows slight differences between classes in method of ascertainment of a tax on net income which is imposed at the same rate on taxpayers of all classes. That case showed a tax imposed on income of a fixed class as to certain corporations, and no tax at all imposed in the very same class of income as to other corporations. That case shows by contrast what is a really arbitrary classification, made on no reasonable or practicable basis, and that no such case is presented here.

The case of *Gulf, etc., R. Co. v. Ellis*, *supra*, again shows an instance of a really arbitrary discrimination. In that case a State statute was attacked which penalized railroads for not paying certain money claims within a certain time after written notice of claim, by authorizing the recovery by the claimant of attorneys' fees in addition to the claim. No such recovery was allowed by any law of the State against

any person or corporation except railroads. The act singled railroads out and punished them for a delinquency for which no one else was punished. The Supreme Court held that there was no reasonable basis for the discrimination; that it was hostile and invalid. Even in that case three judges filed a vigorous dissent.

In the case of *Cotting v. Kansas City Stock Yards, supra*, the court passed upon the validity of a statute of Kansas which provided regulations for stock yards of a certain class, with penalties for violation, but which applied only to stock yards in one city of the State. It was held that the statute denied the equal protection of the laws to the stock yards of that one city; that the classification was arbitrary and unreasonable, because the regulations were not applied to all members of the class within the scope of the power of the State. So, if North Carolina imposed an income tax on such railroads as run through the city of Charlotte, leaving other railroads untaxed as to income, such imposition would undoubtedly be invalid. But the Income Tax Act does just what the statute condemned in the *Cotting case* did not do—that is, it applies to every member of the class within the jurisdiction of the State.

In *Connolly v. Union Sewer Pipe Co., supra*, the court declared to be a violation of the Fourteenth Amendment a State anti-trust act condemning a certain class of combinations and making illegal and void the contracts of such a combination, but expressly exempting from its operation exactly that same class of combination when made by farmers or livestock raisers. That statute was invalid for the same reason as the one condemned in the *Cotting case*—it did not apply to all members of the class affected (certain forms of

combination) within the scope of power of the State. That case is also clearly distinguishable from the case now presented to this court, for here all members of the class within the power of the State are affected and affected exactly alike.

The *Connolly* case is also interesting for the distinction it draws between the general regulatory powers of a State and the broader tax powers under the Fourteenth Amendment, which distinction has been referred to above.

The North Carolina cases cited by the plaintiffs as sustaining their allegation of unconstitutionality under the State uniformity clause, *State v. Williams*, 158 N. C., 610, and *Worth v. Railroad*, 89 N. C., 291, are so patently different from our case that they do not merit extended attention.

In *State v. Williams*, *supra*, the town ordinance was a clear, direct, hostile discrimination against non-resident merchants in favor of residents of the town. Of course, such discrimination was incompetent, just as it would be incompetent for North Carolina to impose an income tax on all railroad corporations incorporated in other States, leaving domestic railroad corporations free from income tax. No such thing has been done. All railroads, all public-service corporations, are taxed upon their income alike.

The case of *Worth v. Railroad*, *supra*, was a plain case of dividing railroad corporations into three classes, and making arbitrary and unreasonable differences in the taxes imposed upon each of the three sub-classes of railroads. Of course, the decision of that case has no pertinency to this discussion.

The appellants contend that it is unconstitutional discrimination against them that they are not allowed deduction from gross earnings of interest on bonded debt, and of rentals paid on long-term leases which amount to purchases

of other roads. We have already shown, under point I, that this is no discrimination at all, in view of the numerous deductions allowed the appellants by virtue of the standard classification of accounts, which deductions are not allowed to individuals and corporations other than public-service corporations, and in view of the fact that individuals are allowed no deduction of living or family expenses, without which expenses the individual or family could not continue to exist.

Section 307 of the act must be considered in connection with the deductions allowed in section 306 and those allowed appellants. That section is as follows:

"SEC. 307. Items not deductible. In computing net income, no deduction shall in any case be allowed in respect of:

"(a) Personal, living, or family expenses.

"(b) Any amount paid out for new buildings or for permanent improvements or betterments, made to increase the value of any property or estate.

"(c) Any amount expended in restoring property for which an allowance is or has been made.

"(d) Premiums paid on any life insurance policy."

Special attention is invited to subsection (b), which will be taken up again a little later in this brief. The statute which permits the Interstate Commerce Commission to provide the forms of accounting for interstate roads is section 8592, subsection (5) of the Compiled Statutes, 1918. This statute was held constitutional in *Interstate Commerce Commission v. Goodrich Transit Co.*, 224 U. S., 191. In the

special instructions of the Commission, effective July 1, 1914, it is declared:

"The accounts prescribed for operating expenses are designed to show expenses of furnishing transportation service, including expenses of maintaining the plant used in the service."

This is, indeed, the key to the whole system of stating operating expenses. All the expenses of operating the railroad and all the expenses of maintaining them up to a definite standard are included in this standard classification of accounts required by the Interstate Commerce Commission. *Kansas City Railway Company v. United States*, 231 U. S., 423.

It is clear that the appellants by the very method of accounting required by the statute, get the full benefit of all the deductions allowed by section 306, except those stated in subsections 2 and 3. In addition to those deductions, they are also entitled to deductions for all expenses of maintenance of way and structures, maintenance of equipment, of traffic, and of transportation and general expenses. Included in these are repairs of all kinds, insurance of all kinds, legal expenses of all kinds, including the payment of damages recovered in actions at law against the railroads, replacements and depreciations of all kinds, many of which are made to increase the value of the property itself. From the nature of the property, it must be kept up to a certain standard, and all these expenses are allowed as deductions, and they are many more than allowed ordinary corporations under section 306, and some of them such items as cannot be deducted by such corporations under section 307.

In the case of other corporations, capital stock is in effect a liability. In applying the Income Tax Act to them, it would be folly to permit them to deduct dividends paid by them to their stockholders. Railroads now are almost wholly financed by bond issues. The interest on those bonds must be paid from their net earnings, just as dividends to the stockholders of ordinary corporations are paid from their net earnings. To refuse to permit railroads, therefore, to deduct payments of interest on their bonded indebtedness in ascertaining income for which they are taxable is not a discrimination forbidden by either the State or Federal Constitution.

That the Interstate Commerce Commission requires income accounts to be kept and reported to it by railroads engaged in interstate commerce, other than the accounts upon which the North Carolina statute bases the net income of these railroads for taxation in the State cannot, we submit, affect the constitution validity of the North Carolina statutes. We think we have shown in the first part of this brief that the Legislature may declare what is the net income of these railroads under the North Carolina Constitution, section 3 of article V. Legislation of this class can deal only with broad, general outlines, from the nature of the subject with which it is dealing. To arrive at the net earnings, net income, of these enormous business enterprises which have ramifications in many directions and whose operations cover a number of States, is necessarily a long and intricate process. The General Assembly when it came to deal with the problem adopted as the basis of its computation these accounts, since 1906 required by the Interstate Commerce Commission to be kept by railroads of the class to which appellants belong.

In addition to the deductions allowed in the adoption of this method, the Legislature allowed also the deduction of uncollectible revenue, taxes paid in this State for the income year and car hire rentals. These last items are included in the income accounts as provided by the Interstate Commerce Commission.

The General Assembly, no doubt, regarded the rentals paid for leased roads as having no analogy to those rentals described in subsection 2, section 306, of the Income Tax Act allowed to individuals and ordinary commercial corporations. As to the appellants, the rentals paid by them for leased roads are not "rentals or other payments required to be made as a condition of the continued use or possession," of the property leased to them. These railroad leases are for very long terms and are accompanied by numerous collateral obligations, which in practical effect make the lessee the owner of the property for the period during which the lease is to run. Naturally, under any system of accounting the rentals paid under such contract are not part of the operating expenses.

But even if there were some discrimination in this respect, it would not be an invalid or unconstitutional discrimination, since it would apply to all members of the class of railroads and other public-service corporations. It is not every difference which constitutes a discrimination, and it is not every discrimination which creates a lack of uniformity under the State Constitution or a denial of equal protection of the laws under the Fourteenth Amendment. There can be no unconstitutionality under those provisions so long as there is competent classification, and every member of the class within the scope of power of the State is treated like

every other member of the class. It is that situation which we have here. The income tax, as applied to the plaintiffs, is neither a violation of the uniformity rule of the State Constitution nor of the Fourteenth Amendment.

If there is no unconstitutional discrimination against the appellants, but a reasonable classification in the Income Tax Act of 1921, then it follows that the income tax levied upon them by reason of their net earnings in the State, even if they include net gains from interstate commerce in the State, is not obnoxious to the commerce clause of the Federal Constitution (*U. S. Glue Co. v. Oak Creek, supra*; *Shaffer v. Carter, supra*) nor to the equal-protection and due-process clauses of the Fourteenth Amendment.

If it is within the constitutional power of a State to differentiate in classification in a tax statute between coal companies producing bituminous coal and those producing anthracite coal, under the circumstances under which that classification was held to be valid in the case of *Heisler v. Thomas Colliery Company*, decided November 27, 1922, we do not see how even a specious or plausible argument can be directed against the classification in the Income Tax Act of 1921 of North Carolina.

We think the opinions in that case and in the case of *Dane v. Jackson*, 256 U. S., 589, and of *Southern Railway Company v. Watts*, this term, contain the answer to every possible contention of the appellants in these suits.

III.

There is no merit in the contention that it is a violation of the State Constitution for the general-property tax to be devoted to local purposes and the various excise, privilege, franchise, and license taxes and the income taxes to be devoted strictly to State purposes.

This same contention was made by these appellants in the cases decided January 2d by this court, and was decided adversely to them.

IV.

This income tax being perfectly valid in itself, the fact of its being imposed in addition to property and franchise taxes cannot affect its validity.

This was decided in *Southern Railway Company v. Watts*, decided January 2, 1923, wherein the court said:

"And there is no basis for the contention that the aggregate burden imposed by the property tax, the franchise tax, and the income tax, operates to obstruct interstate commerce."

V.

The validity of this tax cannot be affected by the fact that it exempts from its operation railroad corporations and other public-service corporations which derive their income not from operation of their property but from other sources.

By their contention that this tax is discriminatory against them because the method of ascertaining net income pre-

scribed by section 202 does not apply to railroad corporations which derive their income from sources other than the operation of their property, the plaintiffs have reference to the case of a railroad corporation which does no railroad business whatever, but which has leased its entire properties for a long term, say ninety-nine years, practically sold its properties, to a corporation which is conducting railroad operations, the lessor having no income whatever except from the rentals paid it by the lessee railroad.

To consider such a point as bearing on the constitutionality of the income tax would verily be to stick in the bark and not to consider the meaning of words, but their form.

When we say that all railroads are taxed alike under this act, we mean by the word "railroads" all corporations engaged in carrying on the business of railroading. We do not mean a corporation which has the word "railroad" as a part of its name, but which does no railroad business, merely leasing for a long term its entire properties to a corporation which is engaged in railroading.

Of course, such a lessor corporation is not taxed under section 202, because it keeps no standard classification of accounts, having only one item of revenue, to wit, the rentals paid it under the lease. It is not a railroad at all. Besides, it must not be forgotten that it is taxed on this income which it receives from rentals, just as any individual is taxed under the income tax under the general provisions of the act.

If the State were compelled to tax such a lessor corporation according to the standard classification of accounts, it would be impossible to tax it at all. It is not only a practical distinction to tax such a corporation under the general pro-

visions of the act, and to tax real railroad corporations under section 202, but it is a distinction which is absolutely necessary.

Another contention, made particularly by the Norfolk and Southern, is that it really pays two income taxes—one on its own income under section 202 and another on the income which it pays to its lessor corporation for the rent of their properties. This is not a situation produced by the laws of North Carolina, but by the voluntary contracts of the plaintiff.

North Carolina enforces against the Norfolk and Southern, as against any other of the plaintiffs, only the tax on its own income as ascertained under section 202. If the Norfolk and Southern is obliged to pay the tax on the income of its lessor, the Atlantic and North Carolina Railroad Company, it is not because any law of North Carolina imposes this obligation, but because the Norfolk and Southern voluntarily assumed this obligation by contract when it leased the properties of the Atlantic and North Carolina and agreed as part of the consideration of the lease to pay all taxes of the lessor.

If the Norfolk and Southern failed to pay lawful taxes of the Atlantic and North Carolina on the latter's income, the lien of the taxes would not be on the property of the Norfolk and Southern, but on that of the Atlantic and North Carolina. And the Norfolk and Southern is forced to pay such taxes, not to avoid a lien on its own property, but to avoid a forfeiture of its lease of the properties of the lessor.

The same situation is true as to all the plaintiffs which lease other smaller railroad lines. They are in the position of attacking the obligation of their own contract.

VI.

There is no merit in the contention that this income-tax statute is in violation of the Interstate Commerce Act, as seeking to prescribe a method of accounting for interstate carriers in conflict with powers delegated to the Interstate Commerce Commission.

The Income Tax Act of 1921 does not prescribe, nor does it seek to prescribe, any method of accounting for interstate carriers in violation of powers delegated to the Interstate Commerce Commission. It very specifically and clearly directs that returns for income tax shall be made strictly according to the accounting system which the said interstate carriers are now using, the standard classification of accounts of the Interstate Commerce Commission, and which they are using under authority of Congress. There is no merit in this contention of the plaintiffs; there is no basis for it in fact.

VII.

This statute is not invalid as being retroactive.

Two of the appellants, Seaboard Air Line and Atlantic Coast Line, contend that the act is invalid in so far as it is retroactive as to income received in January, February, and in the first eight days of March, the act having been ratified and become effective on March 8, 1921, and taxing the income of the taxpayer for the calendar year 1921.

The courts hold uniformly, however, that such an act is

not retroactive within the constitutional inhibitions and is valid.

State v. Bell, 61 N. C., 76;

Stockdale v. Insurance Co., 20 Wall., 323;

Flint v. Stone Tracy Co., 220 U. S., 108;

Brushaber v. Union Pacific R. Co., 240 U. S., at 20.

VIII.

The injunctions prayed were properly refused because, even if the income tax were invalid and were not enjoined, there would be no irreparable injury to the plaintiffs, since they have an adequate remedy at law to recover payments illegally exacted.

The statute here brought in question, in section 701, expressly provides an appeal from the State Tax Commission (now Commissioner of Revenue, Public Laws 1921, ch. 40) to the Superior Court, as follows:

"SEC. 701. *Appeal*.—Any taxpayer may file formal exceptions to any finding by the State Tax Commission with respect to his taxable income, and upon such exceptions being overruled, any such taxpayer shall have the right, upon the payment of the amount of tax found by the State Tax Commission to be due, and upon filing bond for costs in the sum of two hundred dollars, to have the record in such case certified to the Superior Court of the county in which the taxpayer resides, or has his principal place of business, within thirty days after notice by the Tax Commission of its determination, given as provided in section 700 of this act. Thereupon, appropriate proceedings shall be had and the relief, if any, to

which the taxpayer may be found entitled may be granted and any taxes, interest or penalties paid, found by the court to be in excess of those legally assessed, shall be ordered refunded to the taxpayer, with interest from time of payment."

In addition to this, the General Assembly, at its extra session in 1921, chapter 96, enacted the following law:

"SECTION 1. Whenever taxes of any kind are or have been through clerical error, or misinterpretation of the law, or otherwise, collected and paid into the State Treasury in excess of the amount legally due the State, the State auditor shall issue his warrant for the amount so illegally collected, to the person entitled thereto, upon certificate of the head of the department through which said taxes were collected or his successor in the performance of the functions of that department, with the approval of the Attorney General, and the Treasurer shall pay the same out of any funds in the treasury not otherwise appropriated: *Provided*, demand is made for the correction of such error or errors within two years from the time of such payment: *Provided further*, that claims which have arisen within the five years next preceding the ratification of this act shall be presented and made within two years from the ratification of this act."

The court below properly refused the injunctions prayed, because there was no threatened irreparable injury alleged or shown, in view of the statutes above quoted.

Indiana Mfg. Co. v. Koehne, 188 U. S., 681.

In that case it was said:

"The absence of an adequate remedy at law is not shown by an averment in the bill which seeks to enjoin the collection of a tax on property alleged to be exempt from taxation, that a portion of the tax is to be paid to the State of Indiana, which cannot be sued, where under the general tax laws of that State complainant might have had its objections to the assessment reviewed by State board and then have filed a petition with the board of county commissioners to recover it back as wrongfully assessed, and if still unsuccessful, might have appealed from the decision of such board to the courts. Irreparable injury cannot be inferred as the result of the enforcement of an illegal tax, so as to sustain a suit in equity to enjoin its collection, where there is a plain and adequate remedy at law to recover the amount of the tax wrongfully assessed. A Federal court is not vested with jurisdiction of a suit in equity to enjoin the collection of a State tax because the case is one arising under the Constitution and laws of the United States within the meaning of the judiciary act of August 13, 1888, unless there is apparent some ground of equitable jurisdiction recognized by the Federal courts."

This was approved by memorandum opinion in *Foster v. Rowe*, 207 U. S., 581, and in *Dalton Adding Machine Co. v. State Corporation Commission*, 236 U. S., 699.

In addition to the statutes cited and quoted hereinbefore in this brief, section 7979 of the Consolidated Statutes of 1919 provides this remedy for taxpayers, and requires the State Treasurer expressly to refund the money so illegally collected if judgment is obtained for that amount. Section

7979 is a permanent part of chapter 131 of the Consolidated Statutes of 1919, entitled "Taxation," and it is located in article 10 of that section, entitled "General Provisions." It is expressly declared in section 7974, subsection 4: "‘Sheriff.’ Every person who is by law authorized to collect taxes, either State or municipal." Section 7979 is as follows:

"Remedy of Taxpayer for Unauthorized Tax.—

Unless a tax or assessment, or some part thereof, be illegal or invalid, or be levied, or assessed for an illegal or unauthorized purpose, no injunction shall be granted by any court or judge to restrain the collection thereof in whole or in part, nor to restrain the sale of any property for the nonpayment thereof; nor shall any court issue any order in claim and delivery proceedings or otherwise for the taking of any personalty levied on by the sheriff to enforce payment of such tax or assessment against the owner thereof. Whenever any person shall claim to have a valid defense to the enforcement of a tax or assessment charged or assessed upon his property or poll, such person shall pay such tax or assessment to the sheriff; but if, at the time of such payment, he shall notify the sheriff in writing that he pays the same under protest, such payment shall be without prejudice to any defenses or rights he may have in the premises, and he may, at any time within thirty days after such payment, demand the same in writing from the treasurer of the State or of the county, city, or town, for the benefit or under the authority or by request of which the same was levied; and if the same shall not be refunded within ninety days thereafter, may sue such county, city, or town for the amount so demanded, including in his action against the county both State and county tax; and if upon the trial it

shall be determined that such tax or any part thereof was levied or assessed for an illegal or unauthorized purpose, or was for any reason invalid or excessive, judgment shall be rendered therefor, with interest, and the same shall be collected as in other cases. The amount of State taxes for which judgment shall be rendered in such action shall be refunded by the State treasurer."

It is true that this statute permits an injunction in the State courts against the collection of an illegal or invalid tax (*Railroad Co. v. Commissioners*, 148 N. C., 220). In this particular it is not to be followed by the Federal courts. The authority of those courts is limited by section 267 of the Judicial Code (R. S., sec. 723, 36 Stat., 1163), which is as follows:

"Suits in equity shall not be sustained in any court of the United States in any case where a plain, adequate and complete remedy may be had at law."

This is the limit of authority of courts of the United States and it cannot be extended by State legislation.

Whitehead v. Shattuck, 138 U. S., 146.

In these cases the injury apprehended by the plaintiffs is that they will be compelled to pay their income taxes to the State Treasurer: the Southern, \$71,522.06; the Seaboard, \$13,133.09; the Atlantic Coast Line, \$41,686.96, and the Norfolk and Southern, \$19,616.46.

It is paying out of these respective amounts of money which the plaintiffs allege to be an irreparable injury. This can be so only if they cannot bring suit to recover these amounts back from responsible defendants.

The fullest kind of remedy at law is provided whereby the plaintiffs can, like all other taxpayers, recover back all illegally levied or paid taxes. The injury apprehended cannot, therefore, be irreparable, and the injunctions applied for, we respectfully submit, should be refused.

Keokuk & H. Bridge Co., v. Salm, 258 U. S., 122.

We respectfully submit, however, that we have shown upon the merits that none of the contentions of the appellants can be sustained, and that the statute here attacked is valid and constitutional, and that the decree of the District Court should be in all respects affirmed.

JAMES S. MANNING,

Attorney General of North Carolina;

FRANK NASH,

Assistant Attorney General,

Solicitors for Defendants.

WM. P. BYNUM,

GEORGE H. BROWN,

LOCKE CRAIG,

THOS. D. WARREN,

SIDNEY S. ALDERMAN,

Of Counsel.

APPENDIX A.

Form 7.

STATE DEPARTMENT OF REVENUE.

Public-service Corporation Income Tax Return (Railroads) for Calendar Year Ending December 31, 1921.

Name
Business address

We, the undersigned, president and treasurer of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return, including the accompanying schedules and statements, has been examined by him and is, to the best of his knowledge and belief, a true and complete return made in good faith, for the taxable period as stated, pursuant to the Revenue Act for 1921 and the regulations issued under authority thereof.

.....
President.

.....
Treasurer.

Sworn to and subscribed before me, this day of
....., 1922.

.....
.....
(Official capacity)

*Net operating income (when business is wholly within the State).....	\$.....
*Net operating revenue, including equal mileage proportion within this State of the interstate business (when business is in part within and in part without the State).....	\$.....
Other income.....	\$.....
	<hr/>
Total income.....	\$.....
*Operating expenses (when business is wholly within the State).....	\$.....
*Proportionate average of operating expenses (when business is in part within and in part without the State).....	\$.....
*Uncollectible revenue.....	\$.....
Taxes paid in this State, other than income and war profits and excess profits taxes.....	\$.....
	<hr/>
Total deductions.....	\$.....
	<hr/>
Operating income, less deductions.....	\$.....
Plus or minus any credit or debit balance received or paid on account of car hire. And when any railroad is partly within and partly without the State then said net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid.....	\$.....
	<hr/>
Net taxable income.....	\$.....
	<hr/>
Tax at 3 per cent.....	\$.....
Main track mileage (system)	
Main track mileage (State)	

*As per standard Classification of Accounts of Interstate Commerce Commission.

APPENDIX B.

Form 8.

STATE DEPARTMENT OF REVENUE.

*Public-service Corporation Income Tax Return, Other Than
Railroads, for Calendar Year Ending December 31, 1921.*

Name and kind of business.....
Business address.....

We, the undersigned, president and treasurer of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return, including the accompanying schedules and statements, has been examined by him and is, to the best of his knowledge and belief, a true and complete return made in good faith, for the taxable period as stated, pursuant to the Revenue Act for 1921 and the regulations issued under authority thereof.

.....
President.

.....
Treasurer.

Sworn to and subscribed before me, this day of
....., 1922.

.....
(Official capacity)

Operating Revenues, in this State, including mileage proportion of interstate business as per standard Classification of Accounts of Interstate Commerce Commission.....	\$.....
Operating Expenses, as per standard Classification of Accounts of Interstate Commerce Commission	\$.....
Net operating revenue.....	\$.....
All other income.....	\$.....
Total income.....	\$.....
Less taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes.....	\$.....
Net taxable income.....	\$.....
Tax at 3 per cent.....	\$.....

(8953)

TRANSCRIPT OF RECORD.

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1922.

No. 727.

NORFOLK SOUTHERN RAILROAD COMPANY, APPELLANT,

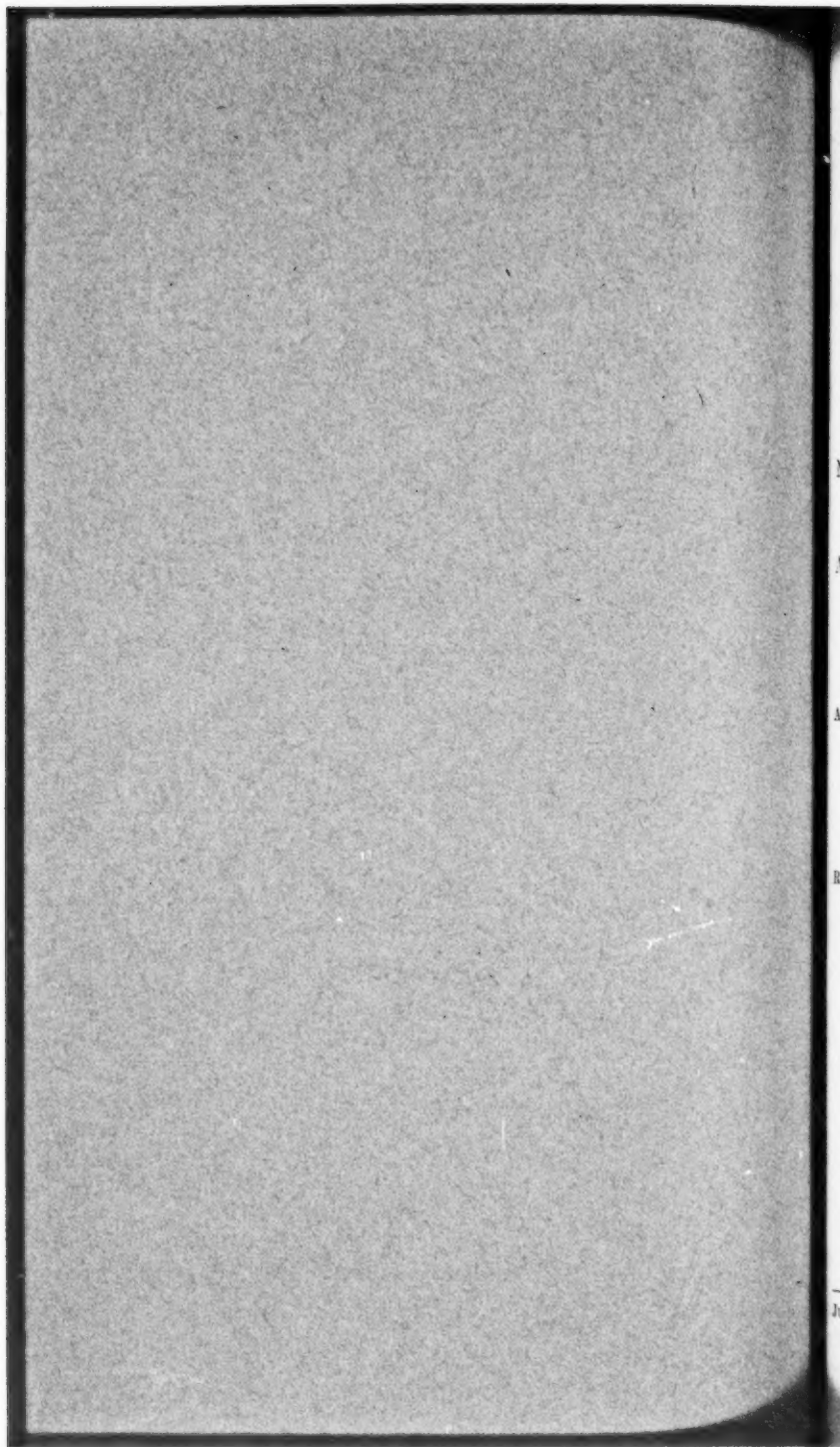
vs.

**A. D. WATTS, COMMISSIONER OF REVENUE, AND JAMES S.
MANNING, ATTORNEY GENERAL OF THE STATE OF
NORTH CAROLINA.**

**APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR
THE EASTERN DISTRICT OF NORTH CAROLINA.**

FILED DECEMBER 11, 1922.

(29,277)



(29,277)

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1922.

No. 727.

NORFOLK SOUTHERN RAILROAD COMPANY, APPELLANT,

vs.

A. D. WATTS, COMMISSIONER OF REVENUE, AND JAMES S. MANNING, ATTORNEY GENERAL OF THE STATE OF NORTH CAROLINA.

APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE EASTERN DISTRICT OF NORTH CAROLINA.

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TRANSCRIPT OF RECORD.

In the District Court of the United States for the Eastern District of North Carolina.

At a District Court of the United States for the Eastern District of North Carolina begun and held at the court-house, in the city of Raleigh, on the fourth Monday after the fourth Monday in October, being the 20th day of November, in the year of our Lord one thousand nine hundred and twenty-two.

Present: The Honorable Henry G. Connor, Judge of the District Court for the Eastern District of North Carolina.

Among others were the following proceedings, to-wit:

In Equity.

NORFOLK SOUTHERN RAILROAD COMPANY

vs.

A. D. WATTS, Commissioner of Revenue, and JAMES S. MANNING, Attorney General of the State of North Carolina.

Bill of Complaint.

Filed April 15, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 450.

NORFOLK SOUTHERN RAILROAD COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue, and JAMES S. MANNING, Attorney General of the State of North Carolina, Defendants.

To the Honorable the Judge of the District Court of the United States for the Eastern District of North Carolina:

Norfolk Southern Railroad Company, a corporation originally created, organized and existing under the laws of the State of Virginia, a citizen and resident of the State of Virginia, brings this its bill against A. D. Watts, individually and as Commissioner of Revenue for North Carolina, and James S. Man-

ning, individually and as Attorney General for North Carolina, citizens and residents of the said State of North Carolina, and thereupon complains and says:

1. Complainant, Norfolk Southern Railroad Com-pany, is a corporation, originally created, organized and existing under and by virtue of the laws of the State of Virginia is a citizen and resident of the State of Virginia, authorized by its charter to conduct and carry on the business of a common carrier of freight and passengers by railroad, not only within the State of Virginia, but beyond its borders, and to engage in interstate and foreign commerce.

2. Defendant, A. D. Watts, is a citizen and resident of the State of North Carolina, holds the office of Commissioner of Revenue, is charged, under the statutes of North Carolina, with the duty of collecting the taxes authorized to be laid and levied under Schedule D, Chapter 34, Public Laws, 1921, being an act entitled "An Act to Raise Revenue," ratified the 8th day of March, 1921, and the amendments and supplements thereto. Said A. D. Watts, as an individual, is a citizen of the Western District of North Carolina; his official residence is at the capital of the State, the City of Raleigh, in the Eastern District of said State. James S. Manning is the Attorney General of the State of North Carolina, is a citizen and resident of said State, and is charged with certain duties in the collection of income taxes under said statute; his individual and official residence is at Raleigh, in the Eastern District of said State.

3. This is a suit in equity, arising under the constitution and laws of the United States, the benefit and protection of which complainant especially sets up and claims. Matters are also involved arising under the constitution and laws of North Carolina, of which matters this court has jurisdiction by reason of diverse citizenship of the parties. The amount in controversy in this case, exclusive of interest and cost, exceeds the sum and value of Three Thousand Dollars, as will be more specifically hereinafter shown.

4. Complainant owns a line of railroad extending from the City of Norfolk, in the State of Virginia, to the City of Charlotte, in the State of North Carolina, together with numerous branch lines, leading from said main line, and has under lease for 91 years, 4 months, from September 1, 1904, a line of railroad owned by Atlantic & North Carolina Railroad Company, extending from Morehead City to Goldsboro, in said State. It has under lease for 99 years from May 20, 1920, a line of railroad owned by Durham & South Carolina Railroad Company, extending from Duncan to Durham, in said State, and had under lease during the year 1921 a line of railroad owned by Carthage & Pinehurst Railroad Company, extending from Pinehurst to Carthage in said State. All of said leased railroads connect with the line of railroad owned by plaintiff. Said lines of railroad are operated by steam, and constitute plaintiff's steam division.

5. Plaintiff owns a line of railroad which is equipped and operated electrically, which is located entirely in Virginia,

and is known as plaintiff's electric division, and connects with its steam division.

Said lines of railroad constitute what is known as "Norfolk Southern Railroad."

During the year 1921, plaintiff conducted and carried on over said lines of railroad, and each and every of them, the business of transporting, as a common carrier by railroad, passengers and property from one state to another, and to and from foreign nations, and was during said year engaged in commerce among the states and with foreign nations; was and is, in the operation of said railroad, subject to the provisions of the Act of Congress approved February 4, 1887, the supplements and amendments thereto, known as the Interstate Commerce Act.

5. Plaintiff is, and was during the year 1921, required by law to keep its accounts according to the standard classification of accounting of Interstate Commerce Commission, and has duly made report of its business of all kinds to the Interstate Commerce Commission in accordance with the Interstate Commerce Act.

Under the rules of the Interstate Commerce Commission plaintiff in making report of the results of its operations for the year 1921 combined the operation of its electric and steam divisions. Plaintiff, however, as a matter of information, was permitted to keep the operating revenues and expenses of the two divisions separate.

6. Atlantic & North Carolina Railroad Company is a corporation created under the laws of the State of North Carolina and owns a line of railroad extending from Morehead City to Goldsboro; Durham & South Carolina Railroad Company is a corporation organized and existing under the laws of the State of North Carolina and owns a line of railroad extending from Duncan to Durham in said State; Carthage & Pinchurst Railroad Company, created under the laws of North Carolina, owns a line of railroad extending from Pinchurst to Carthage, in said State.

Each and every of said companies prior to January 1, 1921, leased their said lines of railroad to this plaintiff for a term of years as hereinbefore set out, except that the lease of the Carthage & Pinchurst Railroad Company expired prior to January 1, 1921, and the operation thereof was continued (notwithstanding the expiration of said lease) until plaintiff could apply to the Interstate Commerce Commission and obtain authority to abandon the same in accordance with the terms of the Interstate Commerce Act, and plaintiff operated the said line of railroad under said lease, paying rent therefor during the year 1921.

7. Neither of said companies were, as common carriers, engaged in commerce among the States or with foreign nations and were not required to keep their records in accordance with the standard classification of accounting of Interstate Commerce Commission.

8. The laws enacted by the General Assembly of North Carolina for raising revenue for the support of the State and its political sub-

7 divisions are set out in what is known as the "Revenue Act," being Chapter 34 of the Public Laws, 1921, and the amendments and supplements thereto.

9. Schedule D of said Act, known as the "Income Tax Act of 1921," and the supplements and amendments thereto, undertake to provide a scheme and plan for levying and collecting a tax upon the "net income" of the citizens of the State, and of non-residents doing business in the State, in accordance with the authority contained in the constitution of the State, Article V, Section 3, which provides:

"Laws shall be passed taxing, by a uniform rule, all moneys, credits, investments in bonds, stocks, joint-stock companies, or otherwise; and, also, all real and personal property, according to its true value in money: Provided, notes, mortgages, and all other evidence of indebtedness given in good faith for the purchase price of a home, when said purchase price does not exceed three thousand dollars, and said notes, mortgages, and other evidence of indebtedness shall be made to run for not less than five nor more than twenty years, shall be exempt from taxation of every kind: Provided, that the interest carried by such notes and mortgages shall not exceed five and one-half per cent. The general assembly may also tax trades, professions, franchises, and income: "Provided, the rate of tax on incomes shall not in any case exceed six per cent (6%), and there shall be allowed the following exemptions, to be deducted from the amount of annual incomes, to wit: for a married man with a wife living with him, or to a widow or widower having minor child or children, natural or adopted, not less than \$2,000; to all other persons not less than \$1,000, and there may be allowed other deductions (not including living expenses) so that only net incomes are taxed."

10. Sections 201 and 202 of said schedule provide as follows:

"Corporations.—Every corporation organized under the laws of this State shall pay annually a franchise or excise tax, with respect to carrying on or doing business, equivalent to three per cent of the entire net income of such corporation, as herein defined, received by such corporation during the income year; and every foreign corporation doing business in this State shall pay annually a franchise or excise tax equivalent to three per cent of a proportion of its entire net income, to be determined according to the following rules:

"In case of a company other than companies mentioned in the next succeeding section, deriving profits principally from the ownership, sale, or rental of real estate or from the manufacture, sale, or use of tangible personal property, such proportion of its entire net income as the fair cash value of its real estate and tangible personal property in this State on the date of the close of the fiscal year of such company in the income year is to the fair cash value of its entire real estate and tangible personal property then owned by it, with no deduction on account of incumbrances thereon.

"In case of a corporation deriving profits principally from the

holding or sale of intangible property, such proportion as its gross receipts in this State for the year ended on the date of the close of its fiscal year next preceding is to its gross receipts for such year within and without the State.

9 "Railroads and Public Service Corporations.—The basis of ascertaining the net income of every corporation engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the Standard Classification of Accounting of the Interstate Commerce Commission, shall be the 'net operating income' of such corporations as shown by their records kept in accordance with that standard classification of accounts, when their business is wholly within this State, and when their business is in part within and in part without the State their net income within this State shall be ascertained by taking their gross 'operating revenues' within this State, including in their gross 'operating revenues' within this State the equal mileage proportion within this State of their interstate business and deducting from their gross 'operating revenues' the proportionate average of 'operating expenses,' or 'operating ratio,' for their whole business, as shown by the Interstate Commerce Commission standard classification of accounts. From the net operating income thus ascertained shall be deducted 'uncollectible revenue,' and taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes, and the balance shall be deemed to be their net income taxable under this act."

11. The net income of all corporations doing business in the State, both domestic and foreign, except those "engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service, when such
10 company is required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, which, or the proportion of which, in the case of foreign corporations, is subject to a tax of three per cent, is ascertainable according to the provisions of Sections 301 to 307 of said schedule, both inclusive. Said sections are set out in full in Exhibit A, hereto attached.

12. Only those corporations which are "engaged in the business of operating steam or electric railroads, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the standard classification of accounting of the Interstate Commerce Commission," are in order to ascertain their net income subject to the provisions of Section 202 of Schedule D. The corporations described in Section 202, for the purpose of ascertaining their "net income" taxable under the act, are authorized to increase or decrease their so called "net operating income" by an addition or deduction of, as to railroads wholly within the state, the whole, and as to those railroads partly within and partly without the state an equal mileage propor-

tion within the state of any credit or debit balance received or paid as the case may be on account of car hire.

13. Only those corporations which are engaged in:

(a) The transportation of passengers or property wholly by railroad, or partly by railroad and partly by water, when both are used under a common control, management or arrangement for a continuous carriage or shipment; or

(b) The transportation of oil or other commodity, except water and except natural or artificial gas, by pipe line, or partly by pipe and partly by railroad or by water; or

(c) The transmission of intelligence by wire or wireless from one state or territory of the United States, or the District of Columbia, to any other state or territory of the United States or the District of Columbia, or from one place in a territory to another place in the same territory, or from any place in the United States through a foreign country to any other place in the United States, or from or to any place in the United States to or from a foreign country, but only in so far as such transportation or transmission takes place within the United States, are required to keep their records according to the Standard Classification of Accounting of the Interstate Commerce Commission.

14. Plaintiff is informed, believes and alleges that there are corporations organized under the laws of North Carolina and corporations not organized under the laws of North Carolina, which are engaged in North Carolina in the business of operating steam or electric railroads, express service, telephone or telegraph business, or other form of public service one or the other, and which are not required to keep records according to the Standard Classification of Accounting of the Interstate Commerce Commission.

12 15. Plaintiff, under the leases which it holds and under which it operates the lines of railroad owned by Atlantic & North Carolina Railroad Company, Durham & South Carolina Railroad Company and Carthage and Pinehurst Railroad Company, is obligated to pay as rent for the continued use of said properties in its trade or business, certain sums of money, and as to the Atlantic & North Carolina Railroad Company, this rent will be increased by the amount of income tax which said company will pay upon its income, and during the income year 1921, paid for such use of said properties the sum of \$160,365.90, which it is contended by the Commissioner of Revenue shall not be deducted from its gross revenue in the State, although such deductions are allowed other corporations.

Substantially the entire income of said three companies is the amount which plaintiff is obligated to pay to them as rent for the continued use of their businesses in its trade or business.

As said statute stands, this plaintiff will have to pay a tax of three per cent upon the amount which it will pay to said companies as rent, and said companies will have to pay an income tax upon that

part of said rent paid to them by this plaintiff, after making therefrom the deductions allowed under Section 306 of said Schedule D. This company has not taken, nor is it taking title to, nor has it any equity in the properties of said companies.

16. As plaintiff is informed, believes and alleges, no other corporation, domestic or foreign, renting property for use in its trade or business, is under said Schedule D required to pay an income tax upon the amount which it pays as rent for property used in its business and at the same time the person or corporation owning the leased property is required to pay an income tax upon the rent so received, unless it be some other corporation required to keep its records in accordance with the Standard Classification of Accounting of the Interstate Commerce Commission.

17. If plaintiff be allowed to make from its gross income the deductions mentioned and set out in Schedule D which are allowed to all domestic and foreign corporations except those required to keep their records according to the Standard Classification of Accounting of the Interstate Commerce Commission, this plaintiff will have no net income subject to tax for the income year ended December 31, 1921.

If this plaintiff be allowed to make from its gross income as defined in Schedule D, Sections 301 to 305, both inclusive, or from that part of said gross income which is derived from business done wholly within said State, together with a mileage proportion of that part of its business done partly within and partly without the same, the deductions set forth in Section 306 that are allowed individuals and corporations, both domestic and foreign, excepting those required to keep their records according to the Standard Classification of Accounting of Interstate Commerce Commission, or that part of such items which are expended wholly within the State, and a mileage proportion of those partly within and partly without the State, this plaintiff will have no net income for the income year 1921, subject to taxation.

18. Railroad companies engaged in commerce among the states, or with foreign nations, operating lines of railroad located partly within and partly without the State of North Carolina, required to keep their records in accordance with the Standard Classification of Accounting of the Interstate Commerce Commission, making reports to the Interstate Commerce Commission, in such reports are required to show their:

- (a) Total Railway Operating Revenue;
- (b) Total Revenue from Miscellaneous Operations;
- (c) Total Railway Operating Expenses; and
- (d) Total Expenses of Miscellaneous Operations.

Plaintiff is advised and so alleges that the terms gross "operating revenue" and gross "operating expenses" as used in said Section 202, if they mean anything, were intended to mean:

(a) As to "operating revenue," that sum which is obtained by the addition of the total revenue derived from railway and miscellaneous operation.

(b) As to "operating expenses," that sum which is obtained by the addition of the total expended in railway and miscellaneous operations.

19. The "per cent total operating expenses to total operating revenue" for the income year 1921 was as follows:

(a) For the steam division located partly in North Carolina and partly in Virginia.....	84.51%
15	
(b) For its electric division located wholly in Virginia and doing no business in North Carolina.....	74.37%
(c) For the entire system, including both divisions.....	83.81%

20. Plaintiff attaches hereto a copy of the return made by it to the Commissioner of Revenue for the income year 1921, which is marked Exhibit B, and is prayed to be taken as a part hereof.

21. Plaintiff avers that under the construction which plaintiff is advised the Commissioner of Revenue (who is charged with the duty of construing said law) has, does and will continue to place upon said schedule, plaintiff will be compelled to pay as income tax for the income year 1921 three per cent upon \$653,882.17 or \$19,616.46.

22. During the said income year 1921, plaintiff had gross income arising from sources other than its operations, both railway and miscellaneous, a portion of which arose in North Carolina, as shown upon said return as follows:

From rent of facilities owned by this Company, and which it permitted other companies to use jointly with it	\$11,766.64
Rent from property not used for common carrier business	10,747.19
Receipts from the use of non-operating physical property	8,645.54
Miscellaneous Income	19,719.29
Total	\$50,878.66

16 These items were shown upon said return to the Commissioner of Revenue, in response to the question, What other income plaintiff had, in addition to its operating, both railway and miscellaneous income.

23. During the said income year 1921, plaintiff in addition to its operating expenses, both railway and miscellaneous, uncollectible revenue, taxes and car hire debit balance, had and paid other expenses in connection with its business in North Carolina, as follows:

(1) For the continued use of common carrier facilities owned by other common carriers in North Carolina, and which this plaintiff was permitted to use jointly with the owner for the conduct of, and which was necessary to enable plaintiff to carry on its business as a common carrier, and to which facilities plaintiff was not taking title, and in which it had no equity	\$34,009.76
(2) Rent for the continued use of property other than common carrier property which property was used in plaintiff's business and to which it had not taken, or was not taking title, and in which it had no equity.....	372.83
(3) Rent of leased railroads, located entirely in North Carolina, the payment of which rent was necessary as a condition of the continued use of said roads in its business, and to which roads it was not taking title and in which it had no equity.....	160,365.96
(4) An equal mileage proportion of interest paid on its funded debt.....	778,351.22
(5) An equal mileage proportion of interest paid on its unfunded debt.....	32,587.06
(6) An equal mileage proportion of discount paid on its funded debt.....	21,755.41
(7) Other expenses of conducting and carrying on its business, which under the standard classification of accounting of the Interstate Commerce Commission, are chargeable to income.	50,778.85
Total other expenses.....	\$1,078,221.09

24. That under said Schedule D, all corporations, both domestic and foreign, except those "engaged in the business of operating a steam or electric railroad, express service, telegraph or telephone business, or other form of public service, when such company is required to keep records according to the Standard Classification of Accounting of the Interstate Commerce Commission," would be and are entitled to deduct from their gross income the amounts, if any, paid by such corporations for and on account of the several items and things mentioned and set out in Section 23 of this bill, in order to ascertain their net income, upon the whole or a portion of which according to the rules set out in Section 201 of said schedule, they would be required to pay an income tax.

25. That as plaintiff is advised, the said Schedule D does not permit or authorize the Commissioner of Revenue to deduct the said expenditures, although made during the income year, and were necessary to be made before plaintiff could have any net income to do with as it saw proper, for that plaintiff is a foreign corporation engaged in operating a steam railroad, and is required to keep its records according to the Standard Classification of Accounting of the Interstate Commerce Commission.

18 26. Said Schedule D, for the purpose of ascertaining the deductions which corporations may make from their gross income in order to ascertain their "net income" subject to tax under said schedule, and under the Constitution of the State undertakes to and does classify corporations.

27. Such classification is purely arbitrary, without any real or actual foundation, having no fair or substantial relation to the proper object sought to be accomplished by the legislation, to-wit, the ascertainment and taxation of the net income of domestic corporations and that portion of the net income of foreign corporations derived from business done in the State.

The only bases for such classification are:

(a) Whether they are of that class of corporations commonly known as public service corporations; and if so

(b) How they are required to keep their records.

28. Said Schedule D does not operate equally and uniformly upon all tax payers in similar circumstances; classifies corporations in an unfair, unreasonable and unjust manner in violation of the uniformity clause of the Constitution of the State of North Carolina and of the Fourteenth Amendment to the Constitution of the United States; denies to the plaintiff the equal protection of the laws and deprives the plaintiff of its property without due process of law.

29. That said Schedule D so classifies corporations as to require plaintiff by reason of its being engaged in interstate commerce,
19 to bear an undue and unjust burden, which does not apply to other corporations, when not engaged in interstate commerce, and directly burdens interstate commerce in violation of the commerce clause of the Constitution of the United States.

30. Said Schedule D imposes heavy penalties upon complainant and other tax payers for failing to make returns as required and/or for failing to pay taxes which are or may be assessed and under the laws of North Carolina any taxes imposed or assessed against plaintiff under said Schedule D constitute a first lien upon plaintiff's property, displacing all other liens and constitute a cloud upon the title of plaintiff to its property.

31. Under Section 7979 of the Consolidated Statutes of the State, wherever a tax levied against a tax payer, or any part of such tax is

illegal or invalid, or is levied for an illegal or unauthorized purpose, a court of equity is authorized to enjoin the collection of such tax, and an injunction may under the laws of the State be issued pendente lite to test the validity of such a tax.

32. This plaintiff is entitled in equity to have the cloud cast upon the title to its property by reason of said illegal tax removed; is entitled to have the collection of said tax enjoined, pending the hearing as to its validity, and is entitled to test the validity of said tax, without being inflicted with heavy and burdensome penalties.

20 33. Plaintiff does not concede that any part of said tax is due and has not therefore tendered any tax.

Whereas, and for as much as complainant is remediless in the premises, according to the common law, and remediable only in equity, and that complainant may not be subjected to the pains and penalties set out in the statutes of North Carolina, and that the cloud may be removed from the title to its said properties, and that complainant may not suffer irreparable damage and that its business of an interstate carrier may not be interfered with or unduly burdened, and that it may not be deprived of its property without due process of law, nor denied the equal protection of the laws, and that the correct amount, if any, of taxes which complainant shall be required to pay to State of North Carolina under said Schedule D of Chapter 34 P. L. 1921 may be ascertained, complainant prays for a writ of subpoena to issue against the defendants commanding them to appear and full and true answer make to this bill of complaint and the several things and matters herein set out, but not under oath, an answer under oath being expressly waived.

That the said defendants in their individual and official capacity be enjoined and restrained from taking any steps to collect said taxes levied and imposed under said Schedule D, or to inflict upon complainant any of the pains or penalties authorized to be imposed under or inflicted by the laws of North Carolina, and that a preliminary injunction be issued pending final hearing and upon final hearing the Commissioner of Revenue be enjoined and commanded to cancel the illegal assessment of said taxes and that the said tax so imposed be declared to be illegal and void and the Commissioner of Revenue and the Attorney General, and their successors in office be perpetually enjoined and restrained from taking any steps to collect said illegal taxes, and from selling plaintiff's property or for the collection or imposing of any fines or penalties for failure to pay said taxes, and for all other, further, general and special relief as in equity it may be entitled to.

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This is the first application for an injunction in this cause.

JOHN M. ROBINSON,
W. B. RODMAN, JR.,
Solicitors for Complainant.

W. B. RODMAN,
C. M. BAIN,
Of Counsel.

STATE OF VIRGINIA,
City of Norfolk:

M. S. Hawkins, being duly sworn, deposes and says that complainant, Norfolk Southern Railroad Company, is a corporation, and that he is one of its officers, to-wit: Secretary; that he has read the foregoing bill of complaint and knows the contents thereof, and that the same is true to his own knowledge, except as to those matters therein stated upon information and belief and as to those he believes it to be true.

M. S. HAWKINS.

Sworn and subscribed to before me this 12th day of April, 1923.

J. R. PRITCHARD,

Notary Public.

My commission expires on the tenth day of January, 1925.

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EXHIBIT A.

Sections 301 to 307, Inclusive, Revenue Act.

Sec. 301. Gross Income Defined.—1. The words "gross income" include gains, profits and income derived from salaries, wages or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, trades, business, commerce or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent dividends, securities, or the transactions of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income of the income year in which received by the taxpayer, unless, under the methods of accounting permitted under this act, any such amounts are to be properly accounted for as of a different period.

2. The words "gross income" do not include the following items which shall be exempt from taxation under this act.

(a) The proceeds of life insurance policies and contracts paid upon the death of the insured to individual beneficiaries or to the estate of the insured.

(b) The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract.

23 (c) The value of property acquired by gift, bequest, devise or descent (but the income from such property shall be included in gross income).

(d) Interest upon the obligations of the United States or its possessions, or of the State of North Carolina.

(e) Salaries, wages, or other compensation received from the United States by officials or employees thereof, including persons in the military or naval forces of the United States.

(f) Any amounts received through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received, whether by suit or agreement, on account of such injuries or sickness.

Sec. 302. Basis of Return of Net Income.—1. Tax payers who customarily estimate their income on a basis other than that of actual cash receipts and disbursements may, with the approval of the Tax Commission, return their net income under this act upon a similar basis. Taxpayers who customarily estimate their income on the basis of an established fiscal year instead of on that of the calendar year, may, with the approval of the Tax Commission, and subject to such rules and regulations as it may establish, return their net income under this act on the basis of such fiscal year in lieu of that of the calendar year.

2. A taxpayer may, with the approval of the Tax Commission and under such regulations as it may prescribe, change the income year from fiscal year to calendar year or otherwise, in which case his net income shall be computed upon the basis of such new income year.

3. An individual carrying on business in partnership shall be liable for income tax only in his individual capacity, and shall include in his gross income the distributive share of the net income of the partnership received by him or distributed to him during the income year.

4. Every individual taxable under this act who is a beneficiary of an estate or trust, shall include in his gross income the distributive share of the net income of the estate or trust, received by him or distributable to him during the income year. Unless otherwise provided in the law, the will, the deed, or other instrument creating the estate, trust or fiduciary relation, the net income shall be deemed to be distributed or distributable to the beneficiaries (including the fiduciary as a beneficiary, in the case of the income accumulated for future distribution), ratably, in proportion to their respective interests.

Sec. 303. Determination of Gain or Loss.—For the purpose of ascertaining the gain or loss from the sale or other disposition of property, real, personal or mixed, the basis shall be, in the case of property acquired before January 1, 1921, the fair market price or value of such property as of that date, if such price or value exceeds the original cost, and in all other cases, the cost thereof: Provided, that in the case of property which was included in the last preceding annual inventory used in determining net income in a return under this act, such inventory value shall be taken in

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lieu of the cost or market value. The final distribution to the taxpayer of the assets of a corporation shall be created as a sale of the stock or securities of the corporation owned by him and the gain or loss shall be computed accordingly. If at any time gains and profits realized by sale of property by other than traders in such property at an increase over the purchase price, or an increase over the fair value of the property on January 1, 1921, shall be held by the Supreme Court of the United States not to be taxable income by the United States Government, such decision shall govern the liability of such gains and profits for taxation as income under this act.

Sec. 304. Exchanges of Property.—1. When property is exchanged for other property, the property received in exchange shall, for the purpose of determining gain or loss, be treated as the equivalent of cash to the amount of its fair market value: Provided, a market exists in which all the property so received can be disposed of at the time of exchange, for a reasonably certain and definite price in cash; otherwise such exchange shall be considered as a conversion of assets from one form to another, from which no gain or loss shall be deemed to arise.

2. In the case of the organization of a corporation, the stock or securities received shall be considered to take the place of property transferred therefor and no gain or loss shall be deemed to arise therefrom.

26 3. When, in connection with the reorganization, merger, or consolidation of a corporation, a tax payer received, in place of stock or securities owned by him, new stock or securities, the basis of computing the gain or loss, if any shall be, in case the stock or securities owned were acquired before January 1, 1921, the fair market price or value thereof as to that date, if such price or value exceeds the original cost, and in all other cases the cost thereof.

Sec. 305. Inventory.—Whenever in the opinion of the Tax Commission the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such tax payer, upon such basis as the Tax Commission may prescribe, conforming as nearly as may be to the best accounting practice in the trade or business and most clearly reflecting the income, and conforming so far as may be to the forms and methods prescribed by the United States Commissioner of Internal Revenue, under the act of Congress than providing for the taxation of income.

Sec. 306. Deductions.—In computing net income there shall be allowed as deductions:

1. All the ordinary and necessary expenses paid during the income year in carrying on any trade or business, including:

(a) As to individuals, wages of employees for services actually rendered in producing such income.

(b) As to partnerships, wages of employees and a reasonable allowance for copartners or members of a firm, for services actually rendered in producing such income, the amount of such salary allowance to be included in the personal return of the copartner receiving same.

(c) As to corporations, wages of employees and salaries of officers, if reasonable in amount, for services actually rendered in producing such income.

2. Rentals or other payments required to be made as a condition of the continued use or possession, for the purposes of the trade of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

3. All interest paid during the income year on indebtedness except interest on obligations contracted for the purchase of non-taxable securities. Dividends on preferred stock shall not be deducted as interest.

4. Taxes for the income year, except taxes on income and war profits, and excess profits taxes, inheritance taxes, and taxes assessed for local benefit of a kind tending to increase the value of the property assessed.

5. Dividends from stock in any corporation the income of which shall have been assessed and the tax on such income paid by the corporation under the provisions of this act: Provided, that when only part of the income of any corporation shall have been assessed under this act only a corresponding part of the dividends received therefrom shall be deducted.

6. Losses sustained during the income year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit.

7. Debts ascertained to be worthless and charged off within the income year, if the amount has previously been included in gross income in a return under this act.

8. A reasonable allowance for the depreciation and obsolescence of property used in the trade or business; and, in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion: Provided, that in computing the deductions allowed under this paragraph, the basis shall be the cost (including in the case of mines, oil, and gas wells, and other natural deposits, the cost of development, not otherwise deducted), and in the case of property acquired prior to January 1, 1921, the fair market value of the property (or the tax payer's interest therein) on that date shall be taken in lieu of cost up to that date. The reasonable allowances under this paragraph shall be made under rules and regulations to be prescribed by the Tax Commission. In the case of leases the deductions allowed may be equitably apportioned between the lessor and lessee.

9. In the case of taxpayers who keep regular books of account, upon an accrual basis and in accordance with standard accounting practice, reserves for bad debts and for contingent liabilities, under such rules and restrictions as the Tax Commission may impose. If the Tax Commission shall at any time deem the reserve excessive in amount it may restore such excess to income, either in a subsequent year or as a part of the income of the income year and assess it accordingly.

10. Contributions or gifts made within the taxable year to corporations or associations operated exclusively for religious, charitable, scientific or educational purposes or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, to an amount not in excess of fifteen per centum of the taxpayer's net income as computed without the benefit of this subdivision.

11. Resident individuals having an established business in another State, or investment in property in another State, may deduct the net income from such business or investment, if such business or investment is in a State that levies a tax upon such net income. The deduction authorized in this subsection shall in no case extend to any part of income of resident individuals from personal services, or mortgages, stocks, bonds, securities and deposits.

12. In the case of a nonresident individual, the deductions allowed in this section shall be allowed only if, and to the extent that, they are connected with income arising from sources within the State; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the State shall be determined under rules and regulations prescribed by the State Tax Commission.

Sec. 307. Items Not Deductible.—In computing net income no deduction shall in any case be allowed in respect of:

(a) Personal, living or family expenses.

(b) Any amount paid out for new buildings or for permanent improvements or betterments, made to increase the value of any property or estate.

(c) Any amount expended in restoring property for which an allowance is or has been made.

(d) Premiums paid on any life insurance policy.

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EXHIBIT B.

State Department of Revenue.

Public Service Corporation Income Tax Return.

(Railroads.)

For Calendar Year Ending December 31, 1921.

Norfolk Southern Railroad Company, Union Station, East Main St.,
Norfolk, Virginia.

We, the undersigned, president and treasurer of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return, including the accompanying schedules and statements, has been examined by him and is, to the best of his knowledge and belief, a true and complete return made in good faith, for the taxable period as stated, pursuant to the Revenue Act for 1921 and the Regulations issued under authority thereof.

G. R. LOYALL,
President.

J. F. GEORGE,
Treasurer.

Sworn to and subscribed before me, this 10th day of April, 1922.

J. R. PRITCHARD,
Notary Public.

My commission expires January 10, 1925.

*Net operating income (when business is wholly within the State).....	\$.....
*Net operating revenue, including equal mileage proportion within this State of the interstate business (when business is in part within and in part without the State).....	.....
Other income.....	.....
See schedule attached as a part hereof.	
Total income.....	\$.....
*Operating expenses (when business is wholly within the State).....	.....
31 *Proportionate average of operating expenses (when business is in part within and in part without the State).....	\$.....
*Uncollectible revenue.....	.....
Taxes paid in this State, other than income and war profits and excess profits taxes.....	.....
Total deductions.....	\$.....
Operating income, less deductions.....	\$.....

*As per standard Classification of Accounts of Interstate Commerce Commission.

Plus or Minus any credit or debit balance received or paid on account of car hire. And when any railroad is partly within and partly without the State then said net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid.....

\$.....

Net taxable income.....

\$.....

Tax @ 3%.....

\$.....

Main track mileage (system) Steam Div.....

900.38

Main track mileage (State) Steam Div.....

829.64

Main track mileage Electric Division Wholly within Virginia..

42.30

Railroads and Public-service Corporations; Basis of Ascertaining Net Income.—The basis of ascertaining the net income of every corporation engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, shall be the "net operating income" of

32 such corporations as shown by their records kept in accordance with that standard classification of accounts, when their business is wholly within this State, and when their business is in part within and in part without the State their net income within this State shall be ascertained by taking their gross "operating revenues" within this State, including in their gross "operating revenues" within this State the equal mileage proportion within this State of their interstate business and deducting from their gross "operating revenues" the proportionate average of "operating expenses," or "operating ratio," for their whole business, as shown by the Interstate Commerce Commission standard classification of accounts. From the net operating income thus ascertained shall be deducted "uncollectible revenue," and taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes, and the balance shall be deemed to be their net income taxable under this act.

Car Hire Considered.—In determining the taxable income of a corporation engaged in the business of operating a railroad under the preceding section, in the case of a railroad located entirely within this State, the net operating income shall be increased or decreased to the extent of any credit or debit balance received or paid, as the case may be, on account of car hire; and when any railroad is located partly within and partly without this State, then said net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid, as the case may be, on account of car hire.

33 *Schedule Attached to and Forming Part of Return of the Norfolk Southern Railroad Company.*

Norfolk Southern Railroad Company, a corporation organized and existing under the laws of the State of Virginia, owning and operating a line of railroad located partly within and partly without the State

of North Carolina, and as common carrier by railroad engaged in interstate commerce, protesting that it is not by law required to make a return to the Commissioner of Revenue for the State of North Carolina of its income for the year 1921, under protest and to avoid penalties, makes the following statement as to its income for the year 1921, from its steam division located partly within and partly without the State, excluding its income from its electric division, which is located entirely within the State of Virginia, where no part of its business is done in North Carolina, and attaches this schedule to the return, which return is made under protest.

Gross Railway Operating Revenue derived from intrastate business in North Carolina, including an equal mileage proportion of the interstate business when partly within and partly without the State of North Carolina	\$6,929,298.03	
Proportionate average of Railway Operating Expenses of line located partly within and partly without the State, where business is done either within or partly within and partly without the State of North Carolina	5,855,949.82	
Balance of Gross Railway Operating Revenue as above, after deducting proportionate average of Railway Operating Expenses as above	\$1,073,348.21	
Miscellaneous operations entirely within the State of North Carolina (Loss)	24,474.17	
34 Net amount received from operations both Railway and Miscellaneous as above	\$1,048,874.04	
Equal mileage proportion of uncollectible railway revenue	\$313.10	
Taxes, except income, excess profit and war taxes	314,838.62	
Equal mileage proportion of car hire debit balance	130,718.81	
		445,870.53
Balance of gross income from operations (both railway and miscellaneous) after deductions as above ..	\$603,003.51	

Other income and expenses, any part of which is derived from sources within North Carolina, excluding dividends from corporations organized under the laws of North Carolina, which corporations pay an income tax to the State of North Carolina, upon their entire net income:

Rent from facilities owned by this company and used jointly by other railroads, joint facility rent	\$11,766.64	
Miscellaneous Rent income	10,747.19	
Miscellaneous Non-operating physical property	8,645.54	
Miscellaneous income	19,719.29	
Total		50,878.66
		<u>\$653,882.17</u>

Expenses Incurred in the Conduct of its Business in North Carolina, other than Expense of Operation, both Railway and Miscellaneous:

Joint Facility Rent (Rent paid for use of facilities of other carriers)	\$34,009.76	
Miscellaneous rent	372.83	
Rent of leased railroad, located entirely in North Carolina, the payment of which rent was necessary as a condition for the continued use of said roads in the conduct of its business	160,365.96	
Equal Mileage proportion of interest on Funded debt	778,351.22	
Equal Mileage proportion of interest on unfunded debt	32,587.06	
Discount on funded debt	21,755.41	
Miscellaneous expenses chargeable to income	50,778.85	
		<u>1,078,221.06</u>
Deficit		<u>\$424,338.92</u>

Application for Interlocutory Injunction.

Filed April 22, 1922.

In the District Court of the United States for the Eastern District of
North Carolina.

In Equity.

No. 450.

NORFOLK SOUTHERN RAILROAD COMPANY

vs.

A. D. WATTS, Commissioner of Revenue for North Carolina, and
JAMES S. MANNING, Attorney General for North Carolina.

Comes the above named plaintiff and shows the court:

That it has instituted in this Court by bill of complaint an action against A. D. Watts, as Commissioner of Revenue of the State of North Carolina, and James S. Manning, as Attorney General for the State of North Carolina, as shown in said bill which is now referred to and made a part of this application, the object and purpose of the action being to secure from this Honorable Court an order enjoining preliminarily and perpetually the defendants, who are tax assessing, collecting, and enforcing officers of the State of North Carolina for the assessment and collection of an income tax sought to be imposed under Schedule D, Chapter 34 of the Public Laws of 1921, commonly known as the Revenue Act of the State of North Carolina.

The bill alleges and sets forth that the said statute is illegal and invalid and that no tax can be assessed against or collected from plaintiff, and further sets forth the grounds of the unconstitutionality of the assessment and of the said statutes of North Carolina, under which the said invalid assessment is made, and under which the taxes alleged to be illegal will be collected by the defendants named in said bill unless restrained by this Honorable Court, all of which is more fully alleged, set out and explained in the bill of complaint filed therein.

Wherefore, application is made under Section 266 of the Judicial Code for an interlocutory injunction as prayed for in said bill, and this Court is petitioned to call to his assistance to hear and determine this application two other judges, and that the statutory notice of the hearing of this application be given the Governor and the Attorney General of the State of North Carolina and each of the defendants to the said bill, and an order issue requiring the defendants to show cause at the time and place to be fixed by this Court according to law why said interlocutory injunction should not issue as prayed for.

This application is based upon the verified bill of complaint on file herein.

W. B. RODMAN,
Attorney for Plaintiff.

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Equity Subpœna.

UNITED STATES OF AMERICA,
Eastern District of North Carolina:

District Court at Raleigh, Fourth Circuit.

The United States of America to A. D. Watts, Commissioner of Revenue, Raleigh, N. C.; James S. Manning, Attorney General, Raleigh, N. C., Greeting:

We command you, and every of you, that you appear before the Judges of our District Court of the United States of America, for the Eastern District of North Carolina, at the office of the Clerk of said Court, in the City of Raleigh, in said District, on the 5th day of May next, to answer the Bill of Complaint of Norfolk Southern Railroad Company, citizen and resident of the State of Virginia, filed in the Clerk's office of said Court, in said City of Raleigh, then and there to receive and abide by such judgment and decree as shall then or thereafter be made, upon pain of Judgment being pronounced against you by default.

To the Marshall of the eastern district of North Carolina to execute.

Witness, The Hon. William Howard Taft, Chief Justice of the Supreme Court of the United States, at Raleigh, in said District, the 15 day of April, 1922, and in the 146 year of the Independence of the United States.

Issued the 15 day of April, 1922.

[Seal of the Court.]

S. A. ASHE,
Clerk U. S. District Court.

The within-named defendants are notified that unless they enter their appearance in the Clerk's office of said District Court at Raleigh and file their answer, or other defense, on or before the 20th day after service hereof, excluding the day of service, the bill filed herein will be taken as confessed and a decree entered accordingly.

S. A. ASHE,
Clerk U. S. District Court.

[Endorsed:] No. 450. Equity. In United States District Court, Eastern District of North Carolina, at Raleigh. Norfolk Southern Railroad Co. against A. D. Watts et al. Equity subpœna. Returnable the 5th day in May, 1922. Duplicate original for ———
———, Solicitors for Complainants.

Marshal's Return on Subpœna.

Filed April 18, 1922.

Received at Raleigh, N. C., April 18, 1922 and executed at Raleigh, N. C., April 18, 1922 by delivering copy to A. D. Watts and J. S. Manning.

R. W. WARD,
U. S. Marshal,
By C. H. HUNNICUTT,
Deputy U. S. Marshal.

Marshal's fees \$4.00.

Extract from the Minutes of the Court, April 15, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 450.

NORFOLK SOUTHERN RAILROAD COMPANY

vs.

A. D. WATTS et al.

Present: The Honorable Henry G. Conner, Judge of the District Court for the Eastern District of North Carolina.

Order.

"It is ordered that this cause be set down for final hearing on its merits on Monday, June 13, 1922, Counsel for Plaintiff and Defendants being in open Court and assenting thereto; application for Interlocutory Injunction being waived by Counsel for Plaintiff."

Answer.

Filed May 5th, 1922.

In the District Court of the United States for the Eastern District of
North Carolina.

In Equity.

No. —.

NORFOLK SOUTHERN RAILROAD COMPANY, Complainant,

v.

A. D. WATTS, Commissioner of Revenue, and JAMES S. MANNING,
Attorney-General of the State of North Carolina, Defendants.

Answer.

To the Honorable H. G. Connor, Judge of the District Court of the
United States for the Eastern District of North Carolina:

The defendants above named, answering the bill herein, respectfully show the Court that:

1. Article I of the bill is admitted.
2. Article II of the bill is admitted.

3. It is admitted that the amount in controversy in this case, exclusive of interest and cost, exceeds the sum of \$3,000. The remainder of Article III of the bill is denied, not being true as stated. Defendants allege that complainant has no valid right to resort to a court of equity, inasmuch as it has an adequate remedy at law in Section 7979 of the Consolidated Statutes of the State of North Carolina and in an act of the Extra Session of 1921, entitled "An act to refund taxes illegally collected and paid into the State treasury."

4. Article IV of the bill is admitted.

- 41 5. Article V of the bill is admitted.

6. Article VI of the bill is admitted.

7. Article VII of the bill is admitted. Said companies, however, are required to pay income tax under other sections of the Income Tax Act of 1921.

8. Article VIII of the bill is admitted.

9. Article IX of the bill is admitted.

10. Article X of the bill is admitted, except as to its first clause, which, having been amended at the Extra Session 1921, should read as follows:

"Sec. 201. Corporations.—Every corporation organized under the laws of this State shall pay annually an income tax equivalent to 3 per cent of the entire net income of such corporation, as herein defined, received by such corporation during the income year; and every foreign corporation doing business in this State shall pay annually an income tax equivalent to 3 per cent of a proportion of its entire net income, to be determined according to the following rules:"

11. Article XI of the bill is admitted.

12. Article XII of the bill is admitted.

13. Article XIII of the bill is admitted, except it is denied that the State of North Carolina levies any income tax upon the net income derived from the business of importing from, or exporting to, any foreign country.

14. Article XIV of the bill is not true as stated, and so is denied. If there are any such corporations, they will pay income tax under the other provisions of the Income Tax Act of 1921.

15. Article XV of the bill is not true as stated, and so is denied. Further answering said article, defendants aver that the Atlantic and North Carolina Railroad Company, Durham and South Carolina Railroad Company, and Carthage and Pinehurst Railroad Company, the lessors of the complainant, are not railroad corporations coming within the classification of Section 202 of the Income Tax Act of 1921, but are subject to the other provisions of said act, and, as such, have to pay 3 per cent income tax on their net income for the year 1921; that the complainants' obligation to pay this income tax arises from the express provision of its contract of lease, and so, when it pays it, it pays it in behalf of these companies and not as an obligation imposed upon it by the Income Tax Law of 1921. The income-tax provision of the Constitution of the State of North Carolina, quoted in Article IX of the bill, authorizes the Legislature to determine what shall be the net income to be taxed thereunder, and expressly prohibits the allowing of any deduction for living expenses. The statute enacted by the General Assembly of 1921 in pursuance of such constitutional authority (Chapters 34 and 35 of the Public Laws of 1921), classifies income-tax payers as follows, providing for each class a different method for ascertaining taxable incomes: first, resident individuals; second, nonresident individuals (Section 200); third, resident corporations; fourth, nonresident corporations (Section 201); fifth, railroads and other public-service corporations having their lines wholly within the State; and sixth, railroads and other public-service corporations having their lines partly within the State and partly without; and the defendants are advised, and so aver, that such classification does not in any way offend against any provision of the State or Federal Constitution. No one of these classes is allowed the same deduction or exemption as those allowed to the other classes, and in each case the distinctions

made are made on account of an inherent difference between the classes themselves. The statute itself (Section 202) provides the method by which the net income of railroads is to be ascertained. It declares that, as to such railroads operating wholly in the State, the net income shall be "the net operating income" as shown by their records, kept in accordance with the standard classification of accounts of the Interstate Commerce Commission. As to railroads, when their business is part within and part without the State, it declares their net income within the State shall be ascertained by taking their gross "operating revenues" within this State, including

43 in their gross "operating revenues" within this State the equal mileage proportion within this State of their interstate business and deducting from their gross "operating revenues" the proportionate average of "operating expenses," or "operating ratio," for their whole business, as shown by the Interstate Commerce Commission standard classification of accounts. From the sum so found, they are allowed to deduct "uncollectible revenues" and taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes, etc., and the balance shall be deemed to be their net income taxable under this act. The method thus provided by the General Assembly for ascertaining the net income of such railroads, as defendants are advised and aver, is both legally and constitutionally a proper one to apply to them, and does not offend against the interstate commerce clause of the Federal Constitution; that deductions and exemptions are allowed individuals which are not allowed ordinary corporations or railroads, and that deductions are allowed ordinary corporations which are not allowed railroads, in specific terms, arises from the necessity to classify income-tax payers, so as to arrive at their net income, and that necessity arises from differences inherent in the various businesses thus classified. Without such classification, defendants are advised and believe, it would be impossible to levy a fair and just income tax. Defendants are advised and believe that, in applying the method provided in the act, many deductions are necessarily allowed, besides those specifically set out in Section 202, "uncollectible revenue," and taxes paid in this State for the income year, etc., i. e., wages of employees, salaries of officers, if reasonable in amount, for services actually rendered in producing such income, and others too numerous to incorporate in this answer. A list of them is hereto attached, marked "Exhibit A," and is asked to be taken as part of this answer.

16. Having fully answered Article XVI of the bill in Article XV. of this answer, the same is here referred to.

44 17. Article XVII of the bill is admitted. Further answering this article, it is admitted that interest paid during the tax year on outstanding bonded and other indebtedness is not one of the deductions allowed to railroads, whereas it is allowed to individuals and business corporations, but many other deductions are allowed to railroads which are not allowed to either individuals and business corporations. See Exhibit A. Defendants are informed

and believe, and so aver, that the method of financing railroads is so wholly different from that of other corporations that they are necessarily in a class to themselves with other public-service corporations, and that a refusal, under such circumstances, to permit a deduction for interest on their bonded indebtedness is justified and is not a discrimination against them. The statute (Section 306, subsection 3) expressly prohibits the deduction of dividends on preferred stock to business corporations. The process of arriving at the net income earned by railroad having part of their line in the State and part out is necessarily long and intricate. The General Assembly, knowing this, and knowing also that the simplest way of arriving at such a net income was by using as a basis the records required to be kept by the Interstate Commerce Commission, adopted that plan and declared in Section 202 what should be the net income of such corporations in its application to them.

18. Article XVIII of the bill, being an interpretation of the statute (Section 202 of the Income Tax Act), has been fully answered in the answers herein numbered 15 and 17.

19. The defendants have no information sufficient to form a belief as to the truth of allegation XIX of the bill, and so it is denied.

20. Defendants admit that the copy of the return made by complainant of income year 1921 is correctly set forth as Exhibit B of the bill.

21. Article XXI of the bill is admitted.

22. Article XXII of the bill is admitted.

23. Article XXIII of the bill, having been fully answered under allegations XV and XVII of this answer, is not true as stated, and so is denied.

24. Article XXIV of the bill is not true as stated, and so is denied, except as admitted herein under allegations XV and XVII of this answer.

25. Article XXV of the bill is admitted.

26. Article XXVI of the bill is admitted.

27. Article XXVII of the bill is not true as stated, and so is denied. Defendants aver, as set out in the answers of Articles XV and XVII, that the classification of the Income Tax Act of 1921 is both legal and constitutional.

28. Article XXVIII of the bill is not true as stated, and so is denied.

29. Article XXIX of the bill is not true as stated, and so is denied.

30. Article XXX of the bill is not true as stated, and so is denied. Defendants expressly deny that the penalties set forth in Section 600 of the Income Tax Act are excessive, unreasonable, oppressive,

and inequitable. Those penalties are imposed for wilful or fraudulent failure to comply with the provisions of the act, and so would not be a denial of due process of law to the complainant. The Revenue Commissioner and the Attorney-General are given authority to waive or reduce the penalties therein provided for.

31. In answer to Article XXXI of the bill, defendants aver that complainant has a complete and adequate remedy at law to recover back any illegal tax paid into the treasury of the State. Under Section 504 of the Income Tax Act, the Commissioner of Revenue may issue an order, under his hand and official seal, directed to the sheriff of any county in the State, commanding him to levy upon and sell the real and personal property of the taxpayer. The payment of such tax, however, will prevent any sale, and the taxpayer is given an adequate remedy at law, under Section 7979 of the Consolidated Statutes of 1919 and in an act of the Extra Session,

46 1921, entitled "An act to refund taxes illegally collected and paid into the State treasury."

32. Article XXXII of the bill is not true as stated, and so is denied.

Wherefore, having fully answered, the defendants pray judgment:

1. That the bill be dismissed.
2. For the cost of the action.
3. For such other and further relief as to the Court may seem just.

JAMES S. MANNING,

Attorney-General of North Carolina,

FRANK NASH,

Assistant Attorney-General of North Carolina,

Solicitors for Defendants.

GEO. H. BROWN,

WM. P. BYNUM,

LOCKE CRAIG,

THOS. D. WARREN,

S. S. ALDERMAN,

Of Counsel.

NORTH CAROLINA,
Wake County:

A. D. Watts, being duly sworn, says that he is Commissioner of Revenue of the State of North Carolina and one of the defendants in the above entitled action; that he knows the contents of the foregoing answer, and it is true, of his own knowledge, except as to matters therein stated on information and belief, and as to those he believes it to be true.

A. D. WATTS.

Sworn and subscribed before me, this May 4, 1922.

EDWARD C. SEAWELL,
Deputy Supreme Court Clerk.

EXHIBIT "A" TO ANSWER.

I. Maintenance of Way and Structures:

Superintendence, roadway maintenance—other; bridges, trestles, and culverts—other; ties—other; rails—other; other track material—other; ballast—other; track laying and surfacing—other; right of way fences—other; crossings and signs—other; station and office buildings; roadway buildings; water stations; fuel stations; shops and engine houses; wharves and docks; telegraph and telephone lines; signals and interlockers; power substation buildings; power transmission systems; power distribution systems; power line poles and fixtures; paving; roadway machines; small tools and supplies; removing snow, ice, and sand; injuries to persons; stationery and printing; other expenses; maintaining joint tracks, yards, and other facilities—Dr.; maintaining joint tracks, yards, and other facilities—Cr.

II. Maintenance of Equipment:

Superintendence; shop machinery; power plant machinery; power substation apparatus; steam locomotives—repairs; steam locomotives—depreciation; other locomotives—repairs; other locomotives—depreciation; freight-train cars—repairs; freight-train cars—depreciation; freight-train cars—retirements; passenger-train cars—repairs; passenger-train cars—depreciation; passenger-train cars—retirements; motor equipment of cars—repairs; motor equipment of cars—depreciation; floating equipment—repairs; floating equipment—depreciation; work equipment—repairs; work equipment—depreciation; injuries to persons; insurance; stationery and printing; other expenses; maintaining joint equipment at terminals—Dr.

III. Traffic:

Superintendence; other agencies; advertising; traffic associations; stationery and printing; other expenses.

IV. Transportation—Rail Line:

Superintendence; dispatching trains; station employees; weighing, inspection, and demurrage bureau; station supplies and expenses; yardmasters and yard clerks; yard conductors and brakemen; yard switch and signal tenders; yard enginemen; yard motormen; fuel for yard locomotives; water for yard locomotives; lubricants for yard locomotives; other supplies for yard locomotives; engine-house expenses—yard; yard supplies and expenses; train enginemen; train motormen; fuel for train locomotives; train power produced; water for train locomotives; lubricants for train locomotives; other supplies for train locomotives; engine-house expenses—train; trainmen; train supplies and expenses; signal and interlocker

operation; crossing protection; drawbridge operation; telegraph and telephone operation; operating floating equipment; stationery and printing; other expenses; insurance; clearing wrecks; damage to property; damage to livestock on right of way; loss and damage—freight; loss and damage—baggage; injuries to persons; operating joint yards and terminals—Dr.; operating joint yards and terminals—Cr.; operating joint tracks and facilities—Dr.; operating joint tracks and facilities—Cr.

VI. Miscellaneous Operations:

Producing power sold.

VII. General:

Salaries and expenses of general officers; salaries and expenses of clerks and attendants; general office supplies and expenses; law expenses; insurance; pensions; stationery and printing; valuation expenses; other expenses; general joint facilities—Dr.

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Affidvit of A. J. Maxwell

Filed June 5, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

SOUTHERN RAILWAY CO. et als., Plaintiffs,

v.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, et als.,
Defendants.

Railroad Income Tax Suits.

Affidavit of A. J. Maxwell.

A. J. Maxwell, being first duly sworn, deposes and says:

Affiant is a member of the State Corporation Commission of North Carolina and has been such since 1910, during which time the said commission was, until 1921, also the State Tax Commission with the duties and functions with reference to administering the tax laws of the State imposed upon the newly created State Department of Revenue by the statute of 1921. In such position the affiant has been directly connected in an official capacity with the administration of the tax laws of the State until the creation of the State Department of Revenue to replace the State Tax Commission as such. In such capacity the affiant was in constant consultation with the finance committees of the General Assembly at the time of the drafting of the Income Tax Act of 1921. In such capacity the

affiant has had extensive experience familiarizing him with the Standard Classification of Accounts of the Interstate Commerce Commission, has made a special and comparative study of the taxation systems of other states and of the subject of taxation.

When the enactment of the Income Tax Act of 1921 was under consideration in the finance committees of the General Assembly, the railroads were heard on the matter and they made the same objection to the provisions of Section 202 that they are now making in these suits. They argued that the application of those provisions to them would not lead to an ascertainment of their net income because certain items, notably interest on bonded indebtedness and rentals paid for leased properties, were not included in the operating expenses in the said Standard Classification, whereas as to individuals and to corporations other than public service corporations deductions were allowed under general terms of the Act which the railroads alleged to be analogous to such interest and rentals.

The legislative committees considered these objections fully and carefully. In enacting the Act in the terms, finally adopted, the General Assembly considered certain well known facts with reference to the method in which railroad corporations are financed. It is a general rule that railroads are financed almost entirely by bond issues, their stock being issued largely incidentally and sometimes even distributed as bonus with the bonds. The rule is that the capital finances are procured by bond issues. This being the case, interest paid on the bonds is properly considered not as a current, operating, or business expense, but as a capital expense. The legislature considered that "net income" as generally understood and as judicially defined means the business revenues less all those expenses incurred in the earning of such revenues, but not deducting any expense on account of or to provide for capital or permanent investment in the business. It was manifest, therefore, that if interest on bonds should be allowed as a deduction in arriving at net income of railroads, this would be the allowing of a capital expense not an operating or business expense, and the result obtained after making such deduction in addition to operating and business expenses would not be the net income of the railroad but less.

With reference to the matters of rentals paid for the lines leased and operated by the railroads, the committees considered the well-known facts that these leases are usually for long terms and with numerous collateral obligations which made them amount practically to purchases of the lessor road's properties by the lessee, and that, this being true, the consideration paid for such long leases of property used fully as if the property of the lessee in its business is really not an operating expense but is by clear analogy and in practical effect a capital expense. If these expenses were allowed as deductions to the plaintiffs, the result would be that they would have no income subject to tax until they had earned enough to provide, not only for all business and operating expenses, but also for all capital expenses and had paid all interest on their bonds; in other words, it would amount to nothing more than a tax on the savings of railroads, which would render the tax utterly incom-

mensurate with that imposed as income tax on individuals and other ordinary corporations.

Affiant states it as his opinion that the Income Tax Act as applied to railroads and other public service corporations under the provisions of Sec. 202 results in a strictly fair and just tax upon their net income, entirely commensurate in scope and burden with the tax imposed on other corporations, and individuals, except that perhaps, in view of the fact that individuals are allowed no deduction whatever for living and family expenses, which expenses are analogous to many items allowed all corporations as deductions, the tax bears relatively more heavily on individuals than on corporations by reason of the constitutional inhibition against allowing such deductions to individuals.

As to the contention of the plaintiffs that it is arbitrary classification and discrimination to base a classification on the question whether the taxpayer is required to keep his accounts in accordance with the Standard Classification, the affiant is advised and believes, and so states, that so long as all railroads are placed within the class and are treated alike without discrimination, the classification is reasonable and not arbitrary, because the distinction of being railroads and not other corporations is a practical and reasonable basis of distinction and classification. Affiant asserts further that all railroads are taxed alike under the Income Tax Act of 1921. All are required to make return for taxation on Income Tax Blank Form 7, according to the Standard Classification of Accounts; and that the class is even broader than that of railroads, including all other public service corporations, these being required to make return on Form 8, according to the same Standard Classification, as sworn to in the affidavit of O. S. Thompson filed by the defendants herein.

When railroads keep the Standard Classification of Accounts, under Federal or State requirement, the only practical method of requiring return for income tax to be made is according to such classification of accounts, and for the State to require different accounting, or to require return according to another system of accounting, would conflict practically with the power of the Interstate Commerce Commission to prescribe uniform classification of accounts. The State of North Carolina has not undertaken to prescribe any system of accounting for the plaintiffs or other railroads in conflict with that already required to be kept by the Interstate Commerce Commission, but has adopted that system as the best and most practical basis for the calculation of net incomes for taxation.

[SEAL.]

A. J. MAXWELL,
Affiant.

Subscribed and sworn to before me this the 5th day of June, 1922

W. H. PITTMAN,
Notary Public.

My commission expires July 29, 1922.

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Affidavit of R. O. Self.

Filed June 5, 1922.

In the District Court of the United States for the Eastern District
of North Carolina.

In Equity.

SOUTHERN RAILWAY COMPANY et als., Plaintiffs,

vs.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, et als.,
Defendants.

Railroad Income Tax Suits.

Affidavit of R. O. Self.

R. O. Self being duly sworn, deposes and says:

Affiant is the clerk of the State Corporation Commission of North Carolina, has been such since the first of September 1919, and as such is the custodian of the records of the said Commission and is thoroughly familiar with the administering by the Commission of its duties and powers given it by statute. He is thoroughly familiar with the classification made by the Corporation Commission of corporations subject to its supervision.

Affiant has read the affidavit of Mr. A. R. Turnbull, President of the Rowland Lumber Company, which affidavit is filed by the Norfolk Southern Railroad Company in these suits, and affiant is familiar with contents thereof. He has also read and is familiar with the contents of the affidavit of Mr. Nathan O'Berry, President of the Enterprise-Whiteville Lumber Company, filed by the said plaintiff in these suits.

The said Rowland Lumber Company, and the said Enterprise-Whiteville Lumber Company do what is known as a limited transportation business, and are authorized by the Commission to carry on their logging roads certain limited commodities other than their own property. These corporations are not railroad Corporations, but are lumbering corporations. Their lines of tramway, or railroad, are constructed by them for the purpose of hauling logs and lumber and operating their lumber business. When such roads are established there are frequent demands by the communities through which they run, for them to transport other commodities for the convenience and accommodation of the inhabitants of those communities. Under Section 3413, Consolidated Statutes, the Corporation Commission has the power to, and in proper cases does, grant authority to such logging or lumber companies to carry for

hire over their logging, or tramway, roads commodities of others within certain limitations.

These corporations are not classed, considered, or treated by the Corporation Commission as railroads, but they are subjected to the supervision of the Commission, chiefly to prevent discrimination as to the very limited carrier service which they are allowed to perform. They are not classed as common carriers, in the same class as railroads such as the plaintiffs in these suits.

As to the Rowland Lumber Company, it entered into the business referred to in the affidavit of Mr. Turnbull not for profit, but purely for the accommodation of the community, as the following quotations from letters and documents will show:

Letter from Mr. A. R. Turnbull, President, Rowland Lumber Company to W. G. Womble, Rate Clerk, State Corporation Commission, Raleigh, N. C., March 22, 1918:

"It is true that we have been handling fertilizer over the west end of our road for the benefit of the people located in that territory. This is merely an accommodation to them, and is of no benefit to us; * * * If these people do not care for this accommodation it will certainly be a great pleasure for us, under present circumstances to discontinue this hauling of freight for them, as it is done absolutely at cost to us on the present basis."

Letter from Stevens & Beasley, Attorneys for the Rowland Lumber Company, to the North Carolina Corporation Commission, dated March 27, 1918. This letter after referring to complaints made by certain citizens of Faison, N. C., against the Rowland Lumber Company for alleged excessive charges for hauling fertilizer, says:

"The Rowland Lumber Company is not operating a logging business, over its road, this year, in Sampson County to any extent but is confining its operations to its log road in Duplin. It has not even determined to open up its road in Sampson County for the carrying of freight as charged, but was simply coming to the rescue of the farmers of Sampson County, and aiding them, as all good citizens should do, in making food for fighting Germany. For all the winter the roads in that section have been almost impassable with an empty vehicle and had the farmers, many of them 15 miles from the railroad, been permitted by the roads to have hauled at all the cost would have been enormous, from \$3 to \$5 per ton and in this emergency the Rowland Lumber Company has been helping them out at great inconvenience to itself and even a loss. Labor conditions are such the cost of operating is so high that no one except a man like Mr. Turnbull would have undertaken to deliver the fertilizer to these people and he regrets that they have been so shortsighted as to kick, for it might have been possible for the road to have been developed into a public carrier under his generous impulses and public spirit. In building the Atlantic & Carolina Railroad, he has done more for Duplin County than any other one man."

The authority granted to the Rowland Lumber Company, as aforesaid, was granted pursuant to petition filed by the Rowland Lumber Company with the Corporation Commission, copy of which is attached hereto and marked Exhibit "A," and which petition shows that it was made purely to accommodate citizens, who requested such service of the Rowland Lumber Company.

On the 27th of February, 1922, Mr. A. R. Turnbull, President of the Rowland Lumber Company, addressed another letter to Mr. W. G. Womble, Rate Clerk, Corporation Commission, in which he said:

"As you will understand we are not operating on piece of road west of Bowden, but are simply hauling fertilizer, etc., for the accommodation of people in that territory. We would be money ahead by discontinuing this service, and will do so if you deem it necessary, but in the meantime, we will do the best we can to give them all the service possible. We have left one locomotive at Bowden to attend to this business and hope to give them better service this year than we have in the past. On the two points, Newton Grove and Eureka Church, however, there will be some delay, and we have notified all shippers whom we know that we do not care to handle this business except in that way."

There is attached hereto and marked Exhibit "B," a schedule of the rates of the Enterprise-Whiteville Lumber Company over its logging road, effective December 1, 1920, as filed with the Corporation Commission, which schedule shows the limitation as to the commodities carried and allowed to be carried by this road.

These logging roads and others similar to them are not classed as railroads and as full common carriers by the Corporation Commission for the reasons above shown, for the reason that their business of carriage of property of others is purely incidental to their business of logging and manufacturing lumber, and is negligible in amount, and for the reason that they maintain no regular schedule of trains, but run simply when there is particular demand for a particular carriage.

R. O. SELF,
Affiant.

Subscribed and sworn to before me this 5th day of June, 1922.

[SEAL.]

W. H. PITTMAN,
Notary Public.

My commission expires July 29, 1922.

EXHIBIT "A."

Rowland Lumber Company.

Norfolk, Va., May 21, 1918.

To the Corporation Commission of North Carolina:

The Rowland Lumber Company respectfully sheweth to the Corporation Commission of North Carolina:

1. That it is a corporation incorporated under the laws of the State of North Carolina, authorized to engage in the Lumber business. In the operation of its timber it has purchased, and caused to be constructed, for logging purposes, a line of railroad running from Bowdens and Warsaw, on the Atlantic Coast Line Railroad, in Duplin County, North Carolina, in a westerly direction for about twenty miles toward Newton Grove.

2. Your petitioner has been, and is continually being, requested by the citizens living along the line of this road to transport freight for them and others; your petitioner is willing to accommodate such parties under present conditions, provided it can do so lawfully.

3. Under Revisal of 1905, Sec. 2598, as amended by Chapter 160, Laws of 1911, your Honorable Body is empowered to authorize this company to transport commodities, and to charge therefor reasonable rates, in addition to the transportation of its own commodities:

Wherefore, your petitioner respectfully prays, that your Honorable Body authorize your petitioner to transport over its logging road, as freight, commodities in carload lots, but excluding lumber and logs, purchased and used along the line of said road, and to make charges therefor; and that this authority be continued from year to year until your petitioner shall give to this Honorable Body necessary notice of its intention to discontinue said service.

Respectfully submitted,

(S.) ROWLAND LUMBER COMPANY,
By A. R. TURNBULL,
President and General Mgr.

EXHIBIT "B."

Rates of Enterprise Lumber Company Railroad.

Effective December 1, 1920.

Fruit and vegetables, per crate.....	20	20	25	25	25
Fruits and vegetables, per car.....	1500	1650	2000	2250	2500
Empty Crates or Barrels, ".....	1500	1650	2000	2250	2500
Ditto each.....	10	10	12½	15	15
Fertilizers, 20 Tons Maximum.....	2500	2600	3250	3500	4000
Fertilizers from 10 to 20 tons, per ton minimum 1,500 per car.....	150	175	200	225	275
L. C. L. per ton.....	300	300	350	400	450
Cotton Seed and Hulls.....	2000	2200	2700	3000	3300
L. C. L. per ton.....	200	250	325	375	400
Holly, Lime and Flour in carload.....	2000	2200	2600	2800	3000
Wood—Minimum 10 cords, per c.....	100	100	110	125	150
Cotton, per bale.....	150	150	150	175	175
Furniture, per 100 pounds.....	25	27	30	30	35
Chickens and eggs, per crate.....	30	20	30	30	30
Mdsc. not classed, per 100.....	20	20	25	25	30
Brick, minimum 10 per m.....	300	300	300	300	350

All freight is to be loaded and unloaded at expense and risk of shipper. We will not accept any freight either carload or L. C. L. from or to any point except the following:

Oliver's Siding.....	3
Taylor's Siding.....	3½
Loftin's Siding.....	3½
King's Crossing.....	5½
Dobson's Crossing.....	7¼
Hill's or Cherry's Siding.....	9½
Scott's Store.....	12
Brown's Camp or Snow Hill.....	13
Woodland Siding C. L. only.....	16
Kornegay's Bridge " ".....	17

All cars have to — unloaded on the same day they are placed, or demurrage will be charged. No freight will be shipped collect: Package freight will be carried out only on Fridays and if placed at warehouse on any day previous to Thursday it will be held by this Company at the shipper's risk. Carload shipments will be taken out any day in the week.

ENTERPRISE LUMBER COMPANY.
THOMAS O'BERRY,
General Mgr.

58

Affidavit of O. S. Thompson.

Filed June 5, 1922.

In the District Court of the United States for the Eastern District
of North Carolina.

In Equity.

SOUTHERN RAILWAY COMPANY et als., Plaintiffs,

vs.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, et als.,
Defendants.

Railroad Income Tax Suits.

Affidavit of O. S. Thompson.

O. S. Thompson being duly sworn, deposes and says:

Since 1906 affiant has been connected with the Corporation Commission of North Carolina, and with the State Department of Revenue since its creation in 1921. The Corporation Commission, in addition to its duties as such, was by statute created the State Tax Commission with the duties of administering the tax laws of the State. Affiant's position with the said State Tax Commission was that of Tax Clerk, and as such his duties were the general super-

vision of the details of the administration of the tax laws of the State. While Tax Clerk of the State Tax Commission affiant had extensive experience with the Standard Classification of Accounts of the Interstate Commerce Commission in connection with preparing the reports of the Corporation Commission based in part on the said Standard Classification.

Affiant is now Deputy Commissioner of Revenue of North Carolina and acting Chief Clerk of the State Department of Revenue and his duties as such are similar to those formerly performed by him as Tax Clerk of said State Tax Commission. Prior to 1906 affiant served as an employee of the Southern Railway Company as clerk handling taxation matters.

In his capacity as Deputy Commissioner of Revenue and acting Chief Clerk of the State Department of Revenue the affiant is familiar with the requirements of that Department as to returns for taxation by taxpayers, with the forms of such returns, and is custodian of the records of the State Department of Revenue. Affiant is familiar with the administration of the tax laws of the State by the State Department.

The State Department of Revenue has only one blank for returns for income tax which is sent out to and used by all railroad corporations engaged in the operation of railroads. This is known as Form 7, and is attached to this affidavit, marked Exhibit A. This form is required by the State Department of Revenue to be filled out by all railroads doing business in the State of North Carolina, whether operating partly within or partly without the State, whether operating wholly within the State but as common carriers with interstate railroads, or whether doing wholly intrastate business. This Form 7 requires a report by all such railroad corporations of their net income as defined by the Income Tax Act of 1921, under the provisions of section 202 of that Act, and based upon and according to the Standard Classification of Accounts of the Interstate Commerce Commission.

59 The State Department of Revenue requires all such railroad corporations to make return for income taxation upon this form and ascertain the net income of such railroads for taxation without discrimination according to the provisions of the said section 202.

Affiant has read the affidavits of Nathan O'Berry, President of the Enterprise-Whiteville Lumber Company, and of Mr. A. R. Turnbull, President of the Rowland Lumber Company, filed in their suits by the Norfolk and Southern Railway Company. It is true that these lumber companies and other similar companies are not classed as railroads by the State Department of Revenue, are not treated as railroads for income tax purposes or for any other purposes whatsoever, and are not required to make returns for income tax according to the Standard Classification of Accounts and upon Form 7, but are required to and do make return for income tax on Form 3, which is the Form required by the Department for corporations in general other than the railroads and other public service corporations taxed according to section 202. In fact, these lum-

ber companies and other similar companies are not railroads and are not public-service corporations. As is stated in the said affidavit by the presidents, their principal business is the lumber business, only such transportation as they carry on is principally the transportation of their own property as incident to the lumber business. Under section 3413, Consolidated Statutes, the Corporation Commission has the power to grant to such companies authority to transport certain commodities other than their own property, subject to the supervision of the Commission, but the affiant is informed and believes that the purpose of such provision is simply to allow such companies to accommodate immediate communities in which they operate; that when such authority is granted to and exercised by such companies they do not engage in the business of transportation as common carriers for others for profit, but only as the purely incidental service of accommodation; that in any such case the transportation of property of others by such a corporation is wholly negligible in amount and purely incidental to the principal business of the corporation, which is the lumber business.

Affiant states, therefore, as a matter of his own knowledge, that the Income Tax Act of 1921, as administered by the State Department of Revenue, applies exactly in the same way and without any discrimination whatsoever to all railroad corporations doing any business in the State engaged in railroad operation, whether foreign or domestic, whether operating partly within and partly without the State, or wholly within the State. All are required to make return for income tax according to the Standard Classification of Accounts and under section 202, and exactly the same deductions are allowed to all, without discrimination.

Not only is the entire class of railroads subjected to income taxation under the provisions of section 202 with ascertainment of net income upon the basis of the Standard Classification of Accounts, but the same is true as to the broader class of all strictly public service corporations, not including such lumber companies as are above referred to and which the affiant is informed and believes are not public-service corporations at all.

The State Department of Revenue has one form for income tax return for all public service corporations other than railroads, Form 8, a copy of which is attached hereto and marked Exhibit B, and which form is substantially identical with Form 7 upon which railroads are required to make return. The Department of Revenue requires, therefore, not only of railroads, but of all other public service corporations, that they file returns for income tax upon the basis of the Standard Classification of Accounts, under the provisions of section 202.

60 Affiant has read the affidavit of Mr. J. H. Bridges, President of the Henderson Water Company, in which Mr. Bridges states that the Henderson Water Company is not required to and does not keep its records according to the Standard Classification of Accounting, and that it did not make return for income taxation according to the said classification under the provisions of section 202. Affiant states that the returns for income taxation in the office

of the Department of Revenue for the year ending December 31, 1921, have not yet been audited and checked for correctness. If what Mr. Bridges says with reference to the return made by the Company is true, his company will be required to amend its return and to file a return on Form 8 according to the said Standard Classification and under the provisions of section 202. As the Department of Revenue interprets the Income Tax Act, the Henderson Water Company, as well as all other public service corporations, are required by it to make return for income tax in accordance with the accounting system of the Standard Classification. The auditing of income tax returns for the said year is in progress at this time, but has not been completed, and, with reference to railroads and other public-service corporations, has been held over pending decision in these suits as to the validity of the income tax as to such corporations, in view of the plaintiff's attack upon the income tax law as applied to them.

O. S. THOMPSON,
Affiant.

Subscribed and sworn before me this the 5th day of June, 1922.

W. H. PITTMAN,
Notary Public.

My commission expires July 29, 1922.

61

Affidavit of F. C. Harding.

Filed June 20, 1922.

In the United States District Court for the Eastern District of North Carolina.

NORFOLK SOUTHERN RAILROAD COMPANY

vs.

A. D. WATTS, Commissioner of Revenue, et al.

F. C. Harding, being duly sworn, deposes and says, that he is the President of the Greenville and Shelberdine Railroad Company; that the same was chartered in 1920; that the road is 12 miles long, extending from Greenville to Shelberdine and is of narrow gauge. That W. L. Hall is the Secretary of said Railroad Company and that David Hoots is General Superintendent, Engineer and Conductor. That this road has no office, either in Greenville or at Shelberdine or along the route of its railroad. That this road makes, as a general thing, one trip a day.

During the movement of fertilizer in the spring, it often makes two trips a day. That it carries freight for hire, from Greenville to any point along the road to Shelberdine and from Shelberdine to any point along the road to Greenville. That it issues no bills of lading.

That the freight it carries from Greenville to Shelberdine, or along the route, is removed from the Atlantic Coast Line Railroad Co. cars and placed in this company's car and is delivered along the route to its several patrons. That while people along the route use this road as a convenience to travel, this company has never charged any passenger rates. That this company has never made any report to the State Corporation Commission or to the Internal Revenue Commissioner and of course has never made any interstate report as it does not do any interstate business as all of its business is intrastate. That this road is not a lumber road. It was originally built for a lumber road but when the Beaufort County Lumber Co. removed from Pitt County, the road was purchased by the present owners who afterwards incorporated under the style above named.

Affiant further states that the Greenville and Shelberdine Railroad Company does not keep its accounts according to the standard classification of accounting promulgated by the Interstate Commerce Commission.

(S.)

F. C. HARDING.

Subscribed and sworn to before me this 20th day of June 1922.

(S.)

M. V. HARDING,

Notary Public.

My commission expires Nov. 3, 1922.

62

Affidavit of Ernest Williams.

Filed June 20, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

NORFOLK SOUTHERN RAILROAD COMPANY

vs.

A. D. WATTS, Commissioner of Revenue, et al.

Affidavit of Ernest Williams.

Ernest Williams, being first duly sworn, deposes and says, that he is President of the Durham & South Carolina Railroad Company; that during the year 1921 the line of railroad owned by the Durham & South Carolina Railroad Company, extending from Durham, North Carolina, to a connection with the line of railroad owned by Norfolk Southern Railroad Company, at Duncan, North Carolina, was under lease to Norfolk Southern Railroad Company for a term of years which has not yet expired.

That Norfolk Southern Railroad Company duly paid the rental required by the said lease, and that the payment of the said rental was a condition precedent for the continued use of said property in the trade or business of Norfolk Southern Railroad Company, and

the rent so paid was substantially the entire income of the Durham & South Carolina Railroad Company.

That Norfolk Southern Railroad Company has not taken title, nor is it taking title, nor has it any equity in the property.

(S.)

ERNEST WILLIAMS.

Subscribed and sworn to before me this 20th day of May, 1922.

[SEAL.]

Florence H. Gilbert,

Notary Public.

My commission expires on the 3rd day of August, 1925.

63

Affidavit of C. D. Bradham.

Filed June 20, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

NORFOLK SOUTHERN RAILROAD COMPANY

vs.

A. D. WATTS, Commissioner of Revenue, et al.

Affidvit of C. D. Bradham.

C. D. Bradham, being first duly sworn, deposes and says that he is President of the Atlantic & North Carolina Railroad Company; that prior to the year 1921, the Atlantic & North Carolina Railroad Company leased to the Howland Improvement Company its line of railroad, extending from Morehead City to Goldsboro, North Carolina.

That the Norfolk Southern Railroad Company is the successor in title to the said leasehold interest granted by said lease and during the year 1921 was in possession of said line of railroad under said lease and used the same exclusively and conducted and carried on the business of a common carrier over said line of railroad.

That during the said year 1921, Norfolk Southern Railroad Company paid the Atlantic & North Carolina Railroad Company the amount of rent required by said lease to be paid for the continued use of said property in the trade or business of Norfolk Southern Railroad Company; that the payment of the said rent was a condition precedent to the continued use of the said property by the Norfolk Southern Railroad Company in its business.

That the Norfolk Southern Railroad Company has not taken title to the said property, was not taking title thereto, and has no equity in the property owned by the Atlantic & North Carolina Railroad Company.

That under the terms of the said lease, Norfolk Southern Railroad Company, as Lessee, is required to pay any Income Tax levied upon the income of the Atlantic & North Carolina Railroad Company derived from or under said lease.

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That the amount of money received from Norfolk Southern Railroad Company as rent for the use of said property is substantially the entire income of the Atlantic & North Carolina Railroad Company.

(S.)

C. D. BRADHAM.

Subscribed and sworn to before me this 17 day of May, 1922.

(S.)

H. J. CARPENTER,

[SEAL.]

Notary Public.

My commission expires on the 7th day of Oct. 1922.

65

Affidavit of M. S. Hawkins.

Filed June 20, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

NORFOLK SOUTHERN RAILROAD COMPANY

vs.

A. D. WATTS et al.

Affidavit of M. S. Hawkins.

M. S. Hawkins, being first duly sworn, deposes and says that he is Secretary of Norfolk Southern Railroad Company, having occupied that position since the Company's organization in 1910.

If it is intended by the affidavit of A. J. Maxwell filed in this cause to suggest that the capital stock of this Company was issued as a bonus or gift, such statement is incorrect and untrue.

Norfolk & Southern Railway Company, predecessor in title of complainant, in many of its properties, issued and sold mortgage bonds to the amount of fourteen million dollars and also certain capital stock, as appears from the records of that company.

Norfolk & Southern Railway Company, being unable to meet its obligations as they matured, the Mortgage securing the bonds was foreclosed and the property was sold and bought by a committee of bondholders who issued the capital stock of the present Norfolk Southern Railroad Company to the bondholders of the Old Norfolk & Southern Railway Company in lieu of the said bonds and stocks.

Under no system of accounting that affiant has ever seen or heard of, can interest paid by an operating corporation be properly charged as a capital expense. Capital expenses are supposed under all proper systems of accounting to represent expenditures made to increase the assets of the Company, while interest is a liability incurred for the use of money borrowed and chargeable to income, and constitutes a liability and not an asset.

A system of accounting which provides for entering interest paid

by an operating corporation as a capital expenditure would be incorrect, misleading and calculated to lead to gross errors, if nothing more.

One of the chief differences between interest and dividend is that interest is a direct obligation of the borrower to pay the lender for the use of money, whether a profit is made or not, while dividends are not a direct obligation to pay at all hazards, as is interest, but dividends can properly be payable only out of net earnings of the business after all expenses, (including interest) and losses, are paid, adjusted, liquidated or taken care of, leaving the capital intact.

Under the Income Tax Laws of North Carolina, as affiant understands them, as to individuals and all corporations other than those required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, the payee, or recipient of the interest, (lender of the borrowed money on which interest accrues) is required to include interest received (except that on certain governmental obligations) in his or its gross income for the purpose of ascertaining the net income subject to tax, and the payer of such interest (borrower of the money) deducts the interest thus paid from his or its gross income, while in the case of dividends the payee, or recipient of the dividends, excludes or omits the dividends from his or its gross income, and the payer of such dividends includes the amount paid as a part of his or its taxable income (provided that the payer pays an income tax to the State) thus the amount so paid as either interest or dividends is only taxed as income one time.

In case of corporations required to keep records according to the standard classification of accounting of the Interstate Commerce Commission (if the statute is held constitutional) both the payee of the interest (that is the lender of the money) and the payer of the interest (the borrower of the money) will be compelled to include the interest received and paid in their gross income, for taxation without allowing any deduction to either, thus making double taxation.

So with rent paid for use of property by individuals and corporations, other than those required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, the payee or lessor of certain property includes rent received in his or its gross income, and the payer of the rent, or lessee of the property, deducts the amount of rent paid from his or its gross income, and the money representing such rent is taxed once only for income purposes, while under the statute, (if constitutional) corporations keeping their records according to the standard classification of accounting of the Interstate Commerce Commission, renting property for use in the business, the payee or lessor of the property, must include the rent received for the use of such property in his or its gross income for the purpose of income taxation, and the payer of such rent, or lessee, is not permitted to deduct such rent from its gross income in order to arrive at the net income taxable, and, therefore, subjecting the rent to double taxation, thus creating a direct discrimination or double taxation on those corporations

which are required to keep their records according to the standard classification of accounting of the Interstate Commerce Commission.

Affiant is advised that only those corporations engaged in operating steam or electric railroads in transportation of passengers and property in Interstate Commerce, and pipe lines carrying certain commodities, and of intelligence, are required to keep records in accordance with the standard classification of accounting of the Interstate Commerce Commission, and therefore, as affiant is advised, informed, and believes, corporations that are engaged in Interstate Commerce in the manner above indicated are penalized for transacting and carrying on interstate commerce.

Affiant is informed, believes and alleges that it is not the general rule that corporations operating railroads engaged in transporting freight and passengers in interstate commerce are financed almost entirely by bond issues.

Norfolk Southern Railroad Company is not financed in that way. As of December 31, 1921 the Company has outstanding capital stock of the par value of sixteen million dollars, and its funded debt was \$19,608,600.00.

Affiant avers that Moody's publication of the financial condition of industrial corporations is a standard authority for the financial condition of such corporations.

An examination of that publication issued for the year 1922 discloses that as to the corporations hereinafter named, which affiant is informed, believes and alleges were during the income tax year 1921, and are now engaged in operating and doing business in the State of North Carolina, as to their relative capital stock issue and funded debt, and bills and accounts payable, as follows, to-wit:

Liggett & Myers Tobacco Co., capital stock \$55,188,300, funded debt \$29,320,600.

Royster Guano Company, capital stock \$2,473,800, and stock of subsidiaries \$331,800, funded debt \$2,500,000, bills and accounts payable \$4,252,175.00.

Virginia Carolina Chemical Company, capital stock \$48,652,972.00, bonds \$26,267,000, bills payable \$27,421,708, total of bonds and bills payable \$53,689,403.00.

Armour & Company, capital stock \$150,000,000.00, bonds \$115,560,900, bills payable \$129,198,913.00.

Consolidated Textile Corporation, capital stock \$26,452,195 with a foot note stating "representing capital, surplus and 801,039 shares of no par value." Bonded debt of \$12,500,000, bills and accounts payable \$14,706,360.00.

Affiant has not had access to Moody's publication as to public utilities for the year 1922, but such publication for the year 1921, as to public utility corporations, discloses that as appears therein, the relative capital stock issue and bonded indebtedness of some of

the public utility corporations, which as affiant is informed, believes and alleges, are not required to keep records in accordance with the standard classification of accounting of the Interstate Commerce Commission, were as follows:

Southern Power Company, capital stock ten million dollars, bonded debt seven million dollars.

Asheville Power & Light Company, of Asheville, N. C., capital stock \$1,639,700, bonded debt \$1,220,000.

Southern Public Utilities Company, capital stock six million dollars, underlying bonds \$1,773,500.00, 5% gold bonds \$4,487,700.

Affiant avers that the real and true difference in financing corporations operating railroads engaged in transporting passengers and property in interstate commerce on the one side and industrial corporations and public utility corporations on the other side, and the reason therefor, arose out of the legal restrictions which have from time to time been placed on and around such railroad corporations and from which industrial corporations are free, i. e. such railroad corporations are not allowed to issue any bonds, stocks or securities except a limited amount of short term notes, until and only to the extent that the duly authorized governmental body shall after investigation find and certify that the issuance of such securities is for some lawful object within its corporate purposes and is compatible with the public interest and is necessary or appropriate and consistent with the proper performance of service to the public and will not impair the ability of such corporation to perform that service and is reasonably necessary for that purpose and after full and complete showing as to the terms upon which the securities are to be sold and the rate of interest they are to bear, while ordinary industrial corporations and many public utility corporations are allowed to issue and sell their securities upon such terms and for such purposes as to them may seem proper; that such railroad corporations are by law prevented from accumulating out of earnings funds with which to discharge (except to a very limited extent) money borrowed to supply the necessary public service, unless such money can be borrowed at a much lower rate than has obtained in the money markets of the world in the last several years, and at a lower rate than the law allows such railroad corporations to earn upon the value of their property devoted to public use, to-wit, 5½ per cent, or unless such railroad corporations deprive the holders of their stock of returns for the use of money invested in such capital stock, and devote the same, if earned, to the discharge of the principal of bonds or securities issued for the benefit of the public, while ordinary industrial corporations are allowed to earn any rate of return which they can, so far as any inhibition of the law provides; that the corporations operating railroads transporting passengers and freight in interstate commerce may be compelled, under heavy penalties, to provide funds with which to furnish services to the public, or quit entirely, which they are not permitted to do, unless and until they have obtained authority so to do from governmental bodies, which authority may be issued only and to the extent that after such investigation the governmental body finds that the public will not be unduly inconvenienced, while industrial corporations are allowed to issue securities whenever they desire, or desist from issuing them, and if they so desire shut down and quit without leave of license from any person or governmental authority whatsoever.

That all the advantages of financing and paying off and discharging loans is with industrial corporations and the limitation of the law against corporations operating railroads transporting freight and passengers in Interstate commerce compel and require them to resort, as far as possible, to the borrowing of money upon long terms, and thus creating obligations which they would not have if the laws were so designed and enacted as to enable such corporations to sell their capital stock.

M. S. HAWKINS.

Sworn and subscribed to before me this 9th day of June, 1922.
J. R. PRITCHARD,
Notary Public.

My commission expires on the 10th day of January, 1925.

70

Affidavit of A. R. Turnbull.

Filed June 20, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

RAILROAD COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.

A. R. Turnbull, being first duly sworn, deposes and says:

1. That he is President of the Rowland Lumber Company.

2. Rowland Lumber Company is a corporation duly organized and existing under the laws of the State of North Carolina, the principal business of the said company is the manufacture of lumber.

3. That it operates a large mill in North Carolina, located at Newbern, and has under lease a line of railroad extending from Clarks Junction, a point on the Atlantic & North Carolina Railroad, westwardly to a point beyond New River and thence to Chinquapin, and a few miles beyond, where it connects with a line of railroad owned by Rowland Lumber Company, which extends to Kenansville, where it connects with a line of railroad owned by Atlantic & Carolina Railroad Company.

4. The principal business of the said railroad running from Kenansville to Clarks Junction, through Chinquapin is the transportation of logs and lumber for the owner of such railroad.

5. The Corporation Commission of North Carolina, acting under the power vested in it by section 3413 Consolidated Statutes of North Carolina, has granted to Rowland Lumber Company authority

to transport commodities of certain kinds and character other than owned by the said Rowland Lumber Company over that part of the said line of railroad between Kenansville and Chinquapin and to charge therefor a scale of rates fixed and established by the Corporation Commission of North Carolina.

6. Rowland Lumber Company does transport for others than itself commodities of the kind and character authorized by said authority to be transported and charges therefor the scale of rates authorized by the Corporation Commission.

7. That the Rowland Lumber Company is not engaged in interstate commerce and has never filed any tariffs with the Interstate Commerce Commission, and has not been authorized to engage in interstate commerce, and is prohibited under the law from so doing until it has filed tariffs with the Interstate Commerce Commission as required by the Interstate Commerce Act.

8. That during the calendar year 1921, which is the income tax year for 1921 in the state of North Carolina, Rowland Lumber Company paid rent for the line of railroad operated by it as aforesaid and also paid other rents for properties used in its said business and to which it had not taken and was not taking title, and to which it had no equity except its leasehold, and also paid sums as interest for money borrowed and used in its business.

9. Affiant is informed and believes that Rowland Lumber Company is, under the income tax law of North Carolina, schedule D, of Chapter 34, entitled to deduct the amounts so paid as interest and rent, together with other deductions allowed by said schedule from its gross income, in order to arrive at its net income subject to tax under the said tax laws of North Carolina.

10. That the said railroad is of standard gauge and can and does receive cars from other lines of railroad, which it transports to destination on its own line.

A. R. TURNBULL.

Sworn and subscribed to before me this 20th day of May, 1922.

[SEAL.]

J. R. DEY, JR.,
Notary Public.

Com. expires Sept. 18, 1923.

Affidavit of Nathan O'Berry.

Filed June 20, 1922.

In the District Court of the United States for the Eastern District of
North Carolina.

RAILROAD COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.

Nathan O'Berry, being first duly sworn, deposes and says:

1. That he is a citizen and resident of the State of North Carolina and County of Wayne, that he is President of Enterprise-Whiteville Lumber Company.

2. That said company is an industrial corporation engaged in operating lumber mills located respectively at Whiteville and Mt. Olive, North Carolina.

3. That said company, as a part of its business constructed a line of railroad extending from Whiteville, N. C., to Butlers, N. C., a distance of about 27 miles, and also constructed a line of railroad extending from Mt. Olive, N. C., to New Camp, N. C., a distance of about 18 miles.

4. That said railroads were established and maintained solely by the owner of the lands upon which the said roads were constructed and the principal business of said railroad is the transportation of logs, lumber and other articles of the owners of said railroad.

5. Acting under the provisions of section 3413 of the Consolidated Statutes of North Carolina, the said corporation applied to the Corporation Commission of North Carolina for authority to said corporation to transport between the termini of said two lines of railroad, commodities other than that owned by the said lumber company, and for authority to charge therefor reasonable rates to be approved by said corporation.

6. The Corporation Commission, under the powers vested in it under said section 3413 of the Consolidated Statutes of North Carolina, duly authorized the said corporation to act as a common carrier between the termini of its said two lines of railroad and established a scale of rates which said corporation might charge for the transportation of the kind and character of commodities
73 which it was authorized to transport for others for such services.

7. That the said Corporation does not have any Tariff filed with Interstate Commerce Commission, and is not authorized to and does

not engage in the transportation of freight or passengers in interstate commerce, or between any points other than those on its own line. That the said corporation, during the year 1921, paid interest on account of money borrowed, that the said corporation in making its income tax returns to the Commissioner of Revenue of the State of North Carolina, deducted from its gross income the interest so paid in order to arrive at its net income, this deduction being made in addition to the other deductions allowed under section 306, schedule D of the Revenue Act of North Carolina.

8. This affiant is informed and believes that it was entirely proper under the laws of North Carolina for said corporation to deduct the interest paid during the year 1921 from its gross income, together with the other deductions allowed in section 306 of schedule D Revenue Act of North Carolina from its gross income in order to ascertain the net income subject to tax.

NATHAN O'BERRY.

Sworn and subscribed to before me this 17th day of May, 1922.

[SEAL.]

G. W. BRINKLEY,

Notary Public.

My Commission expires Jan. 24, 1924.

74 *Affidavit of J. C. Nelms, Jr. (May 18, 1922).*

Filed June 20, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

NORFOLK SOUTHERN RAILROAD COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.

Affidavit.

J. C. Nelms, Jr., being first duly sworn, deposes and says:

That he is a citizen and resident of the County of Norfolk, and State of Virginia; that he is General Auditor of Norfolk Southern Railroad Company and has occupied that position since April, 1915; that he is familiar with the rules of accounting for steam and electric railroads as prescribed by the Interstate Commerce Commission.

On the 19th of May, 1914, effective July 1, 1914, the Interstate Commerce Commission issued orders classifying the accounts of steam railroads, and dividing the accounts into two classes:

- (1) Operating Revenues and Operating Expenses; and,
- (2) Income, Profit and Loss, and General Balance Sheet Accounts.

These rules are still in force, subject to such modifications and explanations as have been made by the Commission since that date.

That the order prescribing the classification of Operating Revenues and Operating Expenses of Steam Roads, among other things provided:

"It is ordered, That, the Classification of Operating Revenues and Operating Expenses of Steam Roads and the text pertaining thereto, embodied in printed form to be hereafter known as Issue of 1914, a copy of which is now before this Commission, be, and is hereby, approved; that a copy thereof duly authenticated by the Secretary of the Commission be filed in its archives, and a second copy thereof, in like manner authenticated, in the office of the Division of Carriers' Accounts; and that each of said copies so authenticated and filed shall be deemed an original record thereof.

75 "It is further ordered, That the said Classification of Operating Revenues and Operating Expenses of Steam Roads, with the text pertaining thereto, be, and is hereby, prescribed for the use of carriers by rail (exclusive of electric railways) subject to the provisions of the Act to Regulate Commerce as amended, in the keeping and recording of their operating revenue and operating expense accounts; that each and every such carrier and each and every receiver or operating trustee of any such carrier be required to keep all operating revenue and operating expense accounts in conformity therewith; and that a copy of said issue be sent to each and every such carrier and to each and every receiver or operating trustee of any such carrier."

This affiant has a copy of the said order and the classification of accounts and instructions accompanying the same.

Accompanying said order, as sent to the carriers, was an introductory letter, which among other things stated that:

"Accounts are provided in this classification for the revenues and expenses of operations which heretofore have been classed as auxiliary or outside operations. The purpose in merging these accounts has been to secure a statement of revenues and expenses in connection with the operation of all physical property the cost of which is includible in the accounts for investment in road and equipment. The accounts for maintenance of physical property have been arranged to correspond with those for the investment in such property. Depreciation accounts have been provided for the current depreciation of fixed improvements, although until further directed the recognition in operation expenses of current depreciation of fixed improvements is optional with the carrier. It is provided that organization and general administration expenses directly assignable to investments in stocks, bonds, and other securities shall be excluded from the accounts of this classification and included in income account No. 549, "Maintenance of investment organization."

There also accompanied said order and classification certain general instructions, among which were the following:

"1. Operating Accounts.—The accounts of this classification are designed to show the revenues and expenses (including the maintenance of the facilities used) of the carrier's railway operations, including rail-line transportation, water-line transportation, if any, and services incident to transportation. Transportation includes the receipt, conveyance, and delivery of traffic."

"4. Miscellaneous Operations.—The revenue and expenses of miscellaneous operations involving the use of such facilities as hotels and restaurants, power plants, cold-storage plants, coal-storage plants, cotton compress plants, wood-preserving plants, ice-supply plants, etc., shall not be included in the accounts of this classification when the facilities used are distinct from those used by the carrier in the service of transportation or in the maintenance of facilities used in transportation service, and the operations are not incident to such service. (See income accounts No. 502, "Revenue from miscellaneous operations," and No. 534, "Expenses of miscellaneous operations," and balance-sheet account No. 705, "Miscellaneous physical property.")"

There also accompanied said order certain special instructions, among which was:

"1. Accounts for Operating Revenues.—The accounts provided for operating revenues are designed to show amounts of money which a carrier becomes entitled to receive from transportation and from operations incident thereto."

The Operating Revenue accounts were by the said classification divided into general accounts and primary accounts. A statement of the general accounts and primary accounts for steam railroads, according to the said classification, showing the number of each account, as set out in said rule and order is hereto attached marked Exhibit A and prayed to be taken as a part of this affidavit.

The said order prescribed that account 142 "Rents of Buildings and other property," should include: "the revenue from the exclusive use of buildings and other property or portions thereof, such as depot and station grounds and buildings, general and other offices, wharves, ferry landings, elevators, stockyards, fuel yards, enginehouses, repair shops, and section and other houses, when the property is operated and maintained in connection with the property used in the carrier's transportation operations and the expenses of maintaining and operating the rented portion cannot be separated from the expenses of that portion used by the carrier."

As to the General Account No. IV, Joint Facility, being primary accounts Nos. 151 and 152, the said order provides that these accounts should include the carrier's proportion of revenue collected by others in connection with the operation of joint tracks, yards, terminals and other facilities, and also that proportion of revenue from the operation of joint tracks, yards terminals and other facilities, which is creditable to other companies.

The account did not include the rent paid for the use of the joint facilities, simply results of operations.

The operating expenses were by said order divided into eight general accounts, and into quite a number of primary accounts. A statement is hereto attached showing the general and primary accounts of steam railroads. Said statement is marked Exhibit B and is

prayed to be taken as a part hereof.

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The special instructions accompanying said order, among other things, stated that: "The accounts prescribed for operating expenses are designed to show expenses of furnishing transportation service, including the expenses of maintaining the plant used in the service."

The accounts of Norfolk Southern Railroad Company are and have been kept in accordance with the rules and regulations prescribed by the Interstate Commerce Commission as set out in said orders, as explained by the instructions and orders of the Commission, modifying or explaining the aforesaid order of May 19, 1914.

The said accounts and reports made to the Commission in accordance with said rules and regulations do not contain any such term as "Net Operating Income." The reports of Norfolk Southern Railroad Company made to the Interstate Commerce Commission show the total amount of its operating revenues and also shows the total amount of its operating expenses, and also the difference between these two amounts, which in said reports, and under the rules prescribed by the Interstate Commerce Commission, is denominated and known as "Net Revenue from Railway Operations." The Net Revenue from Railway Operations of Norfolk Southern Railroad Company and of corporations operating steam or electric railroads, keeping their accounts in accordance with the standard classification of accounting of the Interstate Commerce Commission, is the difference between the amount of money which Norfolk Southern Railroad Company or such other similar corporations, receives from transportation, as the term "Transportation" is defined in the said classification of accounts and in the Interstate Commerce Act, and the amount paid out for "all the ordinary and necessary expenses paid during the income year for conducting and carrying on transportation, as transportation is defined in the said classification of accounts and in the Interstate Commerce Act, including as a part of said expenses depreciation on its equipment, to-wit: steam locomotives, other locomotives, freight train cars, passenger train cars, motor equipment of cars, floating equipment, work equipment and miscellaneous equipment, if any."

Accounts of operating revenues and operating expenses of steam railroads, such as Norfolk Southern Railroad Company, and other similar corporations, kept in accordance with standard classification of accounting of the Interstate Commerce Commission do not include all gain derived from capital or labor or both combined, provided it is understood that the term "gain" includes profit gained through a sale or conversion of capital assets.

The said operating revenues and operating expenses of steam roads does not include the following items of gain or income which such corporations may receive during any period of time, but said items or sources of revenue or gain are in accordance with said classification carried under what is known as income accounts, to-wit: revenues from miscellaneous operations, hire of freight cars, credit balance, rents from locomotives, rents from passenger train cars, rents from floating equipment, rents from work equipment, joint facility rent income, income from lease of road, miscellaneous rent income, miscellaneous non-operating physical property, separately operated properties,—profit, dividend income, income from funded securities, income from unfunded securities and accounts, income from sinking and other reserve funds, release of premiums on funded debt, contributions from other companies, and miscellaneous income, all of which are gain from labor or capital or both combined, or from a sale or conversion of capital assets.

The accounts of operating revenues and operating expenses of steam railroads, when such accounts are kept in accordance with the standard classification of accounting of Interstate Commerce Commission, do not include all of the expenses of conducting and carrying on the business of the corporation, and do not include many items of expenses which are necessary to be paid in order that the business may be carried on, to-wit: railway tax accruals; uncollectible railway revenues; expenses of miscellaneous operations; taxes on miscellaneous operating property; hire of freight cars—debit balance; rent for locomotives; rent for passenger-train cars; rent for floating equipment; rent for work equipment; joint facility rents; rent for leased roads; miscellaneous rents; miscellaneous tax accruals; separately operated properties—loss; interest on funded debt; interest on unfunded debt; amortization of discount on funded debt; maintenance of investment organization; income transferred to other companies; miscellaneous income charges; income applied to sinking and other reserve funds; dividend appropriations of income; income appropriated for investment in physical property; stock discount extinguished through income; and miscellaneous appropriations of income.

Under the aforesaid orders of the Interstate Commerce Commission dividing the accounts of corporations, operating steam railroads engaged in interstate commerce, into the two general classes as aforesaid, to-wit: Operating Revenues and Operating Expenses on the one part, and Income, Profit and Loss, and General Balance Sheet Accounts on the other, the Interstate Commerce Commission prescribed with great care and particularly the items of revenue which should go into each of the income accounts both credit and debit accounts.

A list of the primary accounts constituting the income accounts under said classification, both credit and debit is hereto attached, marked Exhibit C and prayed to be taken as a part hereof.

In addition, the said order of the Commission in prescribing rules of accounting for corporations operating steam railroads engaged in interstate commerce, prescribed a form of income statement. A copy of said form is hereto attached and made a part hereof, marked Exhibit D, and prayed to be taken as a part hereof.

79 The accounts of Norfolk Southern Railroad Company are kept in accordance with the aforesaid classification, its income statement is made to accord with the form of income statement prescribed in said rules of accounting and it reports to the Interstate Commerce Commission its operating revenues, operating expenses, other items of intake and outgo, all as prescribed by the Interstate Commerce Commission.

The term "Operation Ratio" does not appear in said rules of accounting. The term "operating ratio" is generally understood to mean and be that percent which the operating expenses as prescribed by the Interstate Commerce Commission bears to the operating revenues as prescribed by the Interstate Commerce Commission.

The difference between the operating revenue and operating expenses of a corporation operating the steam railroads in keeping its accounts in accordance with the rules of the Interstate Commerce Commission does not show or purport to show the net income of such corporations, but purports to show and shows the difference between the amount of revenue received from the business of conducting and carrying on its transportation and the operations incident thereto and the cost and expense of conducting such transportation and the incidents thereto.

In order to obtain the net income of such corporations it is necessary to consider and take into consideration the income accounts of said corporation as prescribed and shown in the rules of accounting of the Interstate Commerce Commission, and is set out in the form of income statement prescribed by the Commission, and which such railroad companies are required to make to the Commission.

Norfolk Southern Railroad Company owns and operates a line of electric railroad which runs from Norfolk to Virginia Beach and thence to Cape Henry, thence returning to Norfolk. In making reports to the Interstate Commerce Commission under the orders of the Commission the accounts of the electric division and the steam division are combined. Under permission granted by the Interstate Commerce Commission, Norfolk Southern Railroad Company keeps records showing the accounts of the electric division or electric railroad separate from the steam division or steam railroad. No part of the electric railroad is situated in North Carolina. The steam railroad extends and is situated both in North Carolina and Virginia. The ratio of operating expenses to operating revenue of the electric division was for the year 1921, 74.37% and for the steam division 84.51%, and for the entire system including both steam and electric divisions, 83.81%. That is to say that out of every dollar received by Norfolk Southern Railroad Company in payment for services rendered in the conduct of transportation on its electric division, as transportation is defined in classification of accounts of the Interstate Commerce Commission, it paid out in operating expenses, as

80 such operating expenses are defined in said classification of accounts, 74.37 cents. That or its steam division, which is located partly in North Carolina and partly in Virginia, where the business is both local and through, in both states, out of every dollar taken in for services rendered in the conduct of transportation,

both intra and interstate, it became necessary to pay, and the company did pay in operating expenses as operating expenses are defined in said classification, the sum of 84.51 cents. That considering its entire system, both electric and steam, out of every dollar taken in payment for services rendered in transportation, both interstate and intrastate, as transportation is defined in the standard classification of accounting of the Interstate Commerce Commission, it becomes necessary for Norfolk Southern Railroad Company to pay for operating expenses in conducting transportation, as transportation is defined in the classification of accounting of the Interstate Commerce Commission 83.81 cents.

That in addition to the operating expenses aforesaid it became necessary for Norfolk Southern Railroad Company, in order to conduct and carry on its business and especially its business on steam division, to pay sums and items as set out in section 23 of the bill of complaint filed in this case.

During the calendar year 1921, which was the income year 1921, Norfolk Southern Railroad Company paid expenses for conducting and carrying on its business which are not included under the head of operating expenses under the rules of accounting of the Interstate Commerce Commission, as follows, to-wit:

Joint Facility Rents, that is rents for tracks, yards, terminals and other facilities owned or controlled by other carriers, companies or individuals, and in the joint use of which Norfolk Southern Railroad Company participated, in the sum of \$37,366.96 of which \$34,009.76 was allocatable to that part of the road located in North Carolina.

For rent of roads, tracks or bridges, including equipment and other railway property covered by the contract of lease of other companies held under lease or other agreement, by the terms of which the exclusive use and control for operating purposes are secured, the sum of \$160,365.96, the entire amount of which was for properties located in North Carolina.

For the use of miscellaneous property, that is property which was not used in the operation of the railroad, but used in the conduct of its business and necessary so to be used, the sum of \$1,376.63 of which \$372.83 was allocatable to North Carolina.

For interest on its funded debt the sum of \$884,399.57 of which \$778,351.22 was and is allocatable to the State of North Carolina.

For interest on unfunded debt \$37,025.96, of which \$32,587.06 is allocatable to North Carolina.

81 For amortization of discount on funded debt, being a proportion of the discount and expense on funded debt of the company applicable to that period, in accordance with the standard rules of accounting of the Interstate Commerce Commission \$24,719.53 of which \$21,755.41 was and is allocatable to North Carolina.

Other expenses of conducting and carrying on its business which, in the standard classification of accounting of the Interstate Commerce Commission is designated as miscellaneous income charges, the sum of \$57,697.34, of which \$50,778.85 is allocatable to the State of North Carolina.

That Norfolk Southern Railroad Company had not taken title, was not taking title, and had no equity in any of the properties leased, including the railroads or joint facilities, and which are referred to as having been secured for its use in the conduct of its business by payment of the rents aforesaid.

That under the orders of the Commission, the form of accounting prescribed for operating expenses carried accounts "for the current depreciation of fixed improvements." The said orders and instructions further provided that the recognition of and charging out in operating expenses current depreciation of fixed improvements is and was optional with the carrier. Norfolk Southern Railroad Company has never charged out in its operating expenses any current depreciation for fixed improvements.

(S)

J. C. NELMS, JR.

Sworn and subscribed to before me this 18 day of May, 1922.

(S)

GILBERT C. REVEILLE,

[SEAL.]

Notary Public.

My commission expires on the 31st day of August, 1924.

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EXHIBIT A.

Operating Revenue Accounts.

General Accounts.

- I. Transportation—Rail Line.
- II. Transportation—Water Line.
- III. Incidental.
- IV. Joint Facilities.

Primary Accounts.

I. Transportation—Rail line:

- 101. Freight.
- 102. Passenger.
- 103. Excess baggage.
- 104. Sleeping car.
- 105. Parlor and chair car.
- 106. Mail.
- 107. Express.
- 108. Other passenger-train.
- 109. Milk.
- 110. Switching.
- 111. Special service train.
- 112. Other freight-train.
- 113. Water transfers—Freight.
- 114. Water transfers—Passenger.
- 115. Water transfers—Vehicles and live stock.
- 116. Water transfers—Other.

II. Transportation—Water line—

- 121. Freight.
- 122. Passenger.
- 123. Excess baggage.
- 124. Other passenger service.
- 125. Mail.
- 126. Express.
- 127. Special service.
- 128. Other.

III. Incidental—

- 131. Dining and buffet.
- 132. Hotel and restaurant.
- 133. Station, train, and boat privileges.
- 134. Parcel room.
- 135. Storage—Freight.
- 136. Storage—Baggage.
- 137. Demurrage.
- 138. Telegraph and telephone.
- 139. Grain elevator.
- 140. Stockyard.
- 141. Power.
- 142. Rents of buildings and other property.
- 143. Miscellaneous.

IV. Joint Facility—

- 151. Joint Facility—Cr.
- 152. Joint Facility—Dr.

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EXHIBIT B.

Operating Expense Accounts.

General Accounts.

- I. Maintenance of Way and Structures.
- II. Maintenance of Equipment.
- III. Traffic.
- IV. Transportation—Rail line.
- V. Transportation—Water line.
- VI. Miscellaneous operations.
- VII. General.
- VIII. Transportation for investment—Cr.

Primary Accounts.

I. Maintenance of Way and Structures—

- 201. Superintendence.
- 202. Roadway maintenance.
- 203. Roadway—Depreciation.
- 204. Underground power tubes.
- 205. Underground power tubes—Depreciation.
- 206. Tunnels and subways.
- 207. Tunnels and subways—Depreciation.
- 208. Bridges, trestles, and culverts.
- 209. Bridges, trestles, and culverts—Depreciation.
- 210. Elevated structures.
- 211. Elevated structures—Depreciation.
- 212. Ties.
- 213. Ties—Depreciation.
- 214. Rails.
- 215. Rails—Depreciation.
- 216. Other track material.
- 217. Other track material—Depreciation.
- 218. Ballast.
- 219. Ballast—Depreciation.
- 220. Track laying and surfacing.
- 221. Right-of-way fences.
- 222. Right-of-way fences—Depreciation.
- 223. Snow and sand fences and snowsheds.
- 224. Snow and sand fences and snowsheds—Depreciation.
- 225. Crossings and signs.
- 226. Crossings and signs—Depreciation.
- 227. Stations and office buildings.
- 228. Stations and office buildings—Depreciation.
- 229. Roadway buildings.
- 230. Roadway buildings—Depreciation.
- 231. Water stations.
- 232. Water stations—Depreciation.
- 233. Fuel stations.
- 234. Fuel stations—Depreciation.
- 235. Shops and enginehouses.
- 236. Shops and enginehouses—Depreciation.
- 237. Grain elevators.
- 238. Grain elevators—Depreciation.
- 239. Storage warehouses.
- 240. Storage warehouses—Depreciation.
- 241. Wharves and docks.
- 242. Wharves and docks—Depreciation.
- 243. Coal and ore wharves.
- 244. Coal and ore wharves—Depreciation.
- 245. Gas producing plants.
- 246. Gas producing plants—Depreciation.

- 247. Telegraph and telephone lines.
- 248. Telegraph and telephone lines—Depreciation.
- 249. Signals and interlockers.
- 250. Signals and interlockers—Depreciation.
- 251. Power plant dams, canals, and pipe lines.
- 252. Power plant dams, canals, and pipe lines—Depreciation.
- 253. Power plant buildings.
- 254. Power plant buildings—Depreciation.
- 255. Power substation buildings.
- 256. Power substation buildings—Depreciation.
- 257. Power transmission systems.
- 258. Power transmission systems—Depreciation.
- 259. Power distribution systems.
- 260. Power distribution systems—Depreciation.
- 261. Power line poles and fixtures.
- 262. Power line poles and fixtures—Depreciation.
- 263. Underground conduits.
- 264. Underground conduits—Depreciation.
- 265. Miscellaneous structures.
- 266. Miscellaneous structures—Depreciation.
- 267. Paving.
- 268. Paving—Depreciation.
- 269. Roadway machines.
- 270. Roadway machines—Depreciation.
- 271. Small tools and supplies.
- 272. Removing snow, ice and sand.
- 273. Assessments for public improvements.
- 274. Injuries to persons.
- 275. Insurance.
- 276. Stationery and printing.
- 277. Other expenses.
- 278. Maintaining joint tracks, yards, and other facilities—
Dr.
- 279. Maintaining joint tracks, yards, and other facilities—
Cr.

II. Maintenance of Equipment—

- 301. Superintendence.
- 302. Shop machinery.
- 303. Shop machinery—Depreciation.
- 304. Power plant machinery.
- 305. Power plant machinery—Depreciation.
- 306. Power substation apparatus.
- 307. Power substation apparatus—Depreciation.
- 308. Steam locomotives—Repairs.
- 309. Steam locomotives—Depreciation.
- 310. Steam locomotives—Retirements.
- 311. Other locomotives—Repairs.
- 312. Other locomotives—Depreciation.

- 313. Other locomotives—Retirements.
- 314. Freight-train cars—Repairs.
- 315. Freight-train cars—Depreciation.
- 316. Freight-train cars—Retirements.
- 317. Passenger-train cars—Repairs.
- 318. Passenger-train cars—Depreciation.
- 319. Passenger-train cars—Retirements.
- 320. Motor equipment of cars—Repairs.
- 321. Motor equipment of cars—Depreciation.
- 322. Motor equipment of cars—Retirements.
- 323. Floating equipment—Repairs.
- 324. Floating equipment—Depreciation.
- 325. Floating equipment—Retirements.
- 326. Work equipment—Repairs.
- 327. Work equipment—Depreciation.
- 328. Work equipment—Retirements.
- 329. Miscellaneous equipment—Repairs.
- 330. Miscellaneous equipment—Depreciation.
- 331. Miscellaneous equipment—Retirements.
- 332. Injuries to persons.
- 333. Insurance.
- 334. Stationery and printing.
- 335. Other expenses.
- 336. Maintaining joint equipment at terminals—Dr.
- 337. Maintaining joint equipment at terminals—Cr.

III. Traffic—

- 351. Superintendence.
- 352. Outside agencies.
- 353. Advertising.
- 354. Traffic associations.
- 355. Fast freight lines.
- 356. Industrial and immigration bureaus.
- 357. Insurance.
- 358. Stationery and printing.
- 359. Other expenses.

IV. Transportation—Rail line—

- 371. Superintendence.
- 372. Dispatching trains.
- 373. Station employees.
- 374. Weighing, inspection, and demurrage bureaus.
- 375. Coal and ore wharves.
- 376. Station supplies and expenses.
- 377. Yardmasters and yard clerks.
- 378. Yard conductors and brakemen.
- 379. Yard switch and signal tenders.
- 380. Yard enginemen.
- 381. Yard motormen.
- 382. Fuel and yard locomotives.

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383. Yard switching power produced.
384. Yard switching power purchased.
385. Water for yard locomotives.
386. Lubricants for yard locomotives.
387. Other supplies for yard locomotives.
388. Enginehouse expenses—Yard.
389. Yard supplies and expenses.
390. Operating joint yards and terminals—Dr.
391. Operating joint yards and terminals—Cr.
392. Train enginemen.
393. Train motormen.
394. Fuel for train locomotives.
395. Train power produced.
396. Train power produced purchased.
397. Water for train locomotives.
398. Lubricants for train locomotives.
399. Other supplies for train locomotives.
400. Enginehouse expenses—Train.
401. Trainmen.
402. Train supplies and expenses.
403. Operating sleeping cars.
404. Signal and interlocker operation.
405. Crossing protection.
406. Drawbridge operation.
407. Telegraph and telephone operation.
408. Operating floating equipment.
409. Express service.
410. Stationery and printing.
411. Other expenses.
412. Operating joint tracks and facilities—Dr.
413. Operating joint tracks and facilities—Cr.
414. Insurance.
415. Clearing wrecks.
416. Damage to property.
417. Damage to live stock on right of way.
418. Loss and damage—Freight.
419. Loss and damage—Baggage.
420. Injuries to persons.

V. Transportation—Water line—

431. Operation of vessels.
432. Operation of terminals.
433. Incidental.

VI. Miscellaneous operations—

441. Dining and buffet service.
442. Hotels and restaurants.
443. Grain elevators.
444. Stockyards.
445. Producing power sold.
446. Other miscellaneous operations.

VII. General—

- 451. Salaries and expenses of general officers.
- 452. Salaries and expenses of clerks and attendants.
- 453. General office supplies and expenses.
- 87 454. Law expenses.
- 455. Insurance.
- 456. Relief department expenses.
- 457. Pensions.
- 458. Stationery and printing.
- 459. Valuation expenses.
- 460. Other expenses.
- 461. General joint facilities—Dr.

VIII. Transportation for investment—Cr.

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EXHIBIT C.

Income Accounts.

Primary Accounts.

I. Credits:

- 501. Railway operating revenues.
- 502. Revenues from miscellaneous operations.
- 503. Hire of freight cars—Credit balance.
- 504. Rent from locomotives.
- 505. Rent from passenger-train cars.
- 506. Rent from floating equipment.
- 507. Rent from work equipment.
- 508. Joint facility rent income.
- 509. Income from lease of road.
- 510. Miscellaneous rent income.
- 511. Miscellaneous non-operating physical property.
- 512. Separately operated properties—Profit.
- 513. Dividend income.
- 514. Income from funded securities.
- 515. Income from unfunded securities and accounts.
- 516. Income from sinking and other reserve funds.
- 517. Release of premiums on funded debt.
- 518. Contributions from other companies.
- 519. Miscellaneous income.

II. Debits:

- 531. Railway operating expenses.
- 532. Railway tax accruals.
- 533. Uncollectible railway revenues.
- 534. Expenses of miscellaneous operations.
- 535. Taxes on miscellaneous operating property.
- 536. Hire of freight cars—Debit balance.
- 537. Rent for locomotives.

- 538. Rent for passenger-train cars.
- 539. Rent for floating equipment.
- 540. Rent for work equipment.
- 541. Joint facility rents.
- 542. Rent for leased roads.
- 543. Miscellaneous rents.
- 544. Miscellaneous tax accruals.
- 545. Separately operated properties—Loss.
- 546. Interest on funded debt.
- 547. Interest on unfunded debt.
- 548. Amortization of discount on funded debt.
- 549. Maintenance of investment organization.
- 550. Income transferred to other companies.
- 551. Miscellaneous income charges.
- 552. Income applied to sinking and other reserve funds.
- 553. Dividend appropriations of income.
- 554. Income appropriated for investment in physical property.
- 555. Stock discount extinguished through income.
- 556. Miscellaneous appropriations of income.

EXHIBIT D.

Form of Income Statement.

I. Operating income—

- 501. *Railway operating revenues.
- 531. *Railway operating expenses.
- *Net revenue from railway operations.
- 532. *Railway tax accruals.
- 533. *Uncollectible railway revenues.
- *Railway operating income.
- 502. Revenues from miscellaneous operations.
- 534. Expenses of miscellaneous operations.
- Net revenue from miscellaneous operations.
- 535. Taxes on miscellaneous operating property.
- Miscellaneous operating income.
- Total operating income.

II. Non-operating Income—

- 503. Hire of freight cars—Credit balance.
- 504. Rent from locomotives.
- 505. Rent from passenger-train cars.
- 506. Rent from floating equipment.
- 507. Rent from work equipment.
- 508. Joint facility rent income.
- 509. Income from lease of road.

*Includes operations of water lines, if any.

- 510. Miscellaneous rent income.
- 511. Miscellaneous non-operating physical property.
- 512. Separately operated properties—Profit.
- 513. Dividend income.
- 514. Income from funded securities.
- 515. Income from unfunded securities and accounts.
- 516. Income from sinking and other reserve funds.
- 517. Release of premiums on funded debt.
- 518. Contributions from other companies.
- 519. Miscellaneous income.
 - Total non-operating income.
 - Gross income (or loss).

III. Deductions from gross income:

- 536. Hire of freight cars—Debit balance.
- 537. Rent for locomotives.
- 538. Rent for passenger-train cars.
- 539. Rent for floating equipment.
- 540. Rent for work equipment.
- 541. Joint facility rents.
- 542. Rent for leased roads.
- 543. Miscellaneous rents.
- 544. Miscellaneous tax accruals.
- 545. Separately operated properties—Loss.
- 546. Interest on funded debt.
- 90 547. Interest on unfunded debt.
- 548. Amortization of discount on funded debt.
- 549. Maintenance of investment organization.
- 550. Income transferred to other companies.
- 551. Miscellaneous income charges.
 - Total deductions from gross income.
 - Net income (or loss).

IV. Disposition of Net Income:

- 552. Income applied to sinking and other reserve funds.
- 553. Dividend appropriations of income.
- 554. Income appropriated for investment in physical property.
- 555. Stock discount extinguished through income.
- 556. Miscellaneous appropriations of income.
 - Total appropriations.
 - Income balance transferred to credit (or debit) of Profit and Loss.

91

Affidavit of J. C. Nelms, Jr.

Filed June 20, 1922.

In the United States District Court, Eastern District of North Carolina.

In Equity.

NORFOLK SOUTHERN RAILROAD COMPANY

vs.

A. D. WATTS et al.

Affidavit of J. C. Nelms, Jr.

J. C. Nelms, Jr., being first duly sworn, deposes and says: that: Accompanying and constituting a part of the order of the Interstate Commerce Commission, made the 19th of May, 1914, effective July 1st, 1914, and still in force, with such modifications and amendments as may have been made thereto, were certain special instructions of which No. 1 reads as follows:

"Income accounts are those designed to show, as nearly as practicable, for each fiscal period, the total amount of money that a carrier becomes entitled to receive for services rendered, the returns accrued upon investments, the accrued costs paid or payable for the services rendered by it, the losses sustained by it, the amounts accrued for taxes, for use of moneys and for use of properties of others, and the appropriations made from income during the period. The net balance of income (or loss) shall be carried to Profit and Loss."

The order above referred to is the order of the Commission regulating the keeping of records by Interstate Carriers by Railroad, known as "Classification of Income, Profit and Loss, and General Balance Sheet Accounts for Steam Roads."

J. C. NELMS, JR.

Sworn and subscribed to before me this 12th day of June, 1922.

GILBERT C. REVEILLE,
Notary Public.

My commission expires the 31st day of August, 1924.

92 *Testimony of R. O. Self at Hearing Before Judge Connor.*

It is agreed that all affidavits filed in the cause by either of the plaintiffs or by the defendants will be treated as in evidence in all cases.

Mr. R. O. Self, Clerk of the North Carolina Corporation Commission produced a list of the corporations operating as limited common

carriers in North Carolina under authority granted by the State Corporation Commission under section 3413 of the Consolidated Statutes of North Carolina. Also a memorandum adding two other roads was attached, all filed as Exhibit A.

R. O. SELF, witness for the defendant, examined by Judge Manning, testifies as follows:

That the several roads mentioned in Exhibit A were lumber roads, for logging purposes, operating under Section 3413 of the Consolidated Statutes as a limited carrier, with the right to stop at anytime.

93 EXHIBIT "A" TO TESTIMONY OF R. O. SELF.

Office of the Corporation Commission.

STATE OF NORTH CAROLINA:

This is to certify, that the Corporation Commission of North Carolina, acting under power vested in it by Sec. 3413 of the Consolidated Statutes of North Carolina, has granted authority to the corporations named below to conduct and carry on the business of limited common carriers between the points designated as to each of the corporations named, and that said corporations have filed with the Corporation Commission of North Carolina tariffs establishing the rate of charges which they are authorized to make for the transportation of commodities between the points named.

The corporations named and the points between which they are authorized to act as limited common carriers, engaged in Intrastate Commerce in North Carolina over a line of steam railroad, are as follows:

Andrews Manufacturing Company, Between Andrews and Old Road Gap, a distance of 8 miles, of thereabouts.

Carr Lumber Company, Between Pisgah Forest and Vanderbilt Boundary, a distance of about 20 miles.

Empire Manufacturing Company, Between Oliver Station to within three miles of Bentonville, about 13 miles.

Enterprise Lumber Company, Between Mount Olive and New Camp, a distance of 18 miles, or thereabouts.

Fishing Creek Timber & Railroad Company, Between Stamper, N. C., and Coffield's Bridge, about 10 miles.

Carolina Southern Railroad, Between Hollister and Vaughan, a distance of 14½ miles, or thereabouts.

Montgomery Lumber Company, Between Spring Hope and Bunn, N. C., a distance of 10 miles or thereabouts.

94 Ocono Luffy Railroad Company, Between Ocono Luffy, N. C., and Smokemont, N. C., about 10 miles.

Rowland Lumber Company, Between Bowdens, N. C., and Warsaw, N. C., toward Newton Grove, a distance of about 20 miles.

Waccamew Lumber Company, Between Bolton and Makatoka, a distance of about 18 miles.

Weldon Lumber Company, Between Weldon, N. C., and a point near Ringwood, a distance of about 20 miles.

Whiteville Lumber Company, Between Whiteville, N. C., and Buttler, a distance of about 27 miles.

Mill Creek Valley Railroad Between — and — a distance of about — miles.

Suncrest Lumber Co., Sunburst to Canton.

Hilton Railroad & Logging Co., Hilton Creek to Island Creek, 6 miles.

Done at the office of the Corporation Commission, at Raleigh, on this the — day of May 1922, by the Corporation Commission, through W. T. Lee, its Chairman, and under the seal of the said Commission.

95 *Testimony of C. J. Joseph at Hearing Before Judge Connor.*

C. J. Joseph, Tax Agent of the A. C. L. Railroad, witness for the Plaintiff, examined by Mr. Thomas W. Davis, testifies as follows:

That he had for a great many years been the tax agent of that road, with the duty of checking and looking after all the taxes of that Company and its affiliated lines in Virginia, North and South Carolina, Georgia, Florida and Alabama. That he was familiar with this litigation and with the Income Tax Laws of North Carolina: that he has to keep up with the stocks and bonds and statistics of the various roads mentioned: that he is familiar with the commercial and financial Chronicle, a financial trade paper, circulated throughout the United States, that collects roads and industrial corporations and their stocks and bonds. The issue of May 27, 1922, of that paper was offered in evidence, and Mr. Davis desired to read into the record the capital stock and bonds of certain industrial corporations reporting to the North Carolina Tax Commission, the Tax Commission showing the capital, but not the bonds issued by them.

96 EXHIBIT TO TESTIMONY OF C. J. JOSEPH.

Representative Partial List of Industrial Corporations Doing Business in North Carolina and Reporting to the North Carolina Corporation Commission and Commissioner of Revenue Financed by Bonds and Stocks.

American Agricultural Chemical Company:

Common stock	\$33,322,126
Preferred Stock	28,455,200
First Mortgage bonds	6,252,000
1st Ref. Mortgage s. f. gold bonds, Series "A" ..	30,000,000

American Sugar Refining Company:

Common Stock	45,000,000
Preferred Stock	45,000,000
15 Year Gold Bonds	30,000,000

American Tobacco Company:

Common Stock "A"	40,242,400
Common Stock "B"	49,344,200
Preferred Stock	52,699,700
Gold Bonds	371,950
Gold Bonds & Cons, Tobacco Collateral Trust	
Trust Mortgage Bonds	1,365,300
Series of Gold Notes	10,000,000
8% Dividend Certificates	8,058,834

Dupont, I. E., de Nemours & Company:

Common stock	63,378,300
Debenture Stock	71,243,250
10 Year Gold Bonds	35,000,000

Galena Signal Oil Company:

Common Stock	16,000,000
Preferred Stock	2,000,000
New Preferred Stock	4,000,000
Convertible Debenture	6,000,000
Entire Stock of Subsidiary Companies	2,800,000
Galena Signal Oil of Texas Bonds	2,800,000

General Electric Company:

Common Stock	176,329,100
Debenture for Sprague Stock	2,047,000
Debenture	15,136,500
Debenture Bonds	15,000,000

Kelly Springfield Tire Company:

Common Stock	9,096,000
Preferred Stock	3,137,100
Second Preferred	5,625,200
10 Year s. f. Gold Notes	10,000,000

97 Morris Company:

1st Mortgage	\$17,626,000
10 Year s. f. Gold Notes	15,000,000
Wm. F. Mosser Co. 10 yr. s. f. notes	3,000,000

Swift & Company:

Common Stock	150,000,000
1st Mortgage s. f. Gold Bonds	28,923,500
Gold Notes	65,000,000

Texas Company:

Stock	164,450,000
3 yr. S. F. Notes	22,772,000

98

Final Decree.

Filed Nov. 13, 1922.

In the District Court of the United States for the Eastern District of
North Carolina, Raleigh Division.

Equity, No. 450.

NORFOLK SOUTHERN RAILROAD COMPANY

vs.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, and
JAMES S. MANNING, Attorney General of North Carolina.

Decree.

This is a suit in equity, brought by plaintiff, Norfolk Southern Railroad Company, a corporation chartered and organized under the laws of the State of Virginia, operating a line of railway in and through the State of North Carolina and the Eastern District thereof, against defendant, A. D. Watts, individually, and as Commissioner of Revenue of North Carolina and James S. Manning, Attorney General of said State, seeking an injunction restraining and enjoining said defendants from taking or causing to be taken any action toward enforcing the filing of a return or the collection of a tax or any part thereof, imposed, or sought to be imposed by the State of North Carolina, upon the plaintiff, under or by virtue of the provisions of the Public Laws of North Carolina of 1921, Chapter 34, known as the Revenue Act or the Income Tax Act, as amended by the General Assembly of North Carolina at its Special Session of 1921.

Following the service of process on the defendants and filing answer to the bill, the cause was set down for hearing upon the bill, answer and evidence.

Plaintiff alleges that, by the provisions of Article 5, Section 3 of the Constitution of North Carolina, the General Assembly is authorized to pass laws.

"Taxing, by a uniform rule, all moneys, credits, investments in bonds, stocks, joint-stock companies, or otherwise, and also real and personal property, according to its true value in money. * * *

The General Assembly may also tax trades, professions and incomes.

99 Provided the rate of tax on incomes shall not, in any case, exceed six per cent, and there shall be allowed the following exemptions, to be deducted from the amount of annual incomes to-wit: For a married man, with a wife living with him, or to a widow or widower having minor child or children, natural or adopted, not less than \$2,000.00; to all other persons not less than \$1,000; and there may be allowed other deductions (not including living expenses), so that only net incomes are taxed."

Pursuant to the provisions of the foregoing Art. of the Constitution, the General Assembly, at its Session of 1921, enacted a statute providing for levying, collecting and paying an income tax on individuals and corporations. Chap. 34 Public Laws of North Carolina and known as a part of the Revenue Act of 1921, or, so far as it relates to the Income Tax, as the "Income Tax Act of 1921."

The sections of this Act pertinent to the questions presented for decision by the plaintiff's contention are:

Section 101. Purpose.—

"The general purpose of this act is to impose a tax for use of the State Government, upon the net income for the calendar year 1921, in excess of exemptions herein set out, collectible in the year 1922 and annually thereafter:

(a) Of every citizen of the State.

(b) Of every domestic corporation.

(c) Of every foreign corporation and of every non resident individual having a business or agency in this State in proportion to the net income of such business or agency.

"Except as otherwise provided in this Act, the purpose is to conform to the definitions of income in the revenue laws of the United States Government and regulations made under its authority in so far as they apply."

"The tax imposed upon the net income of corporations in this Schedule is in addition to the tax imposed under Schedule "C" of this Act."

Section 201. Corporations.—

Every corporation organized under the laws of this State shall pay annually an income tax equivalent to three per cent of the entire net income of such corporation, as herein defined, received by such corporation during the income year; and every foreign corporation doing business in this State shall pay annually an income tax equivalent to three per cent of a proportion of its entire net income, to be determined according to the following rules.

In case of a Company other than Companies mentioned in the next succeeding section, deriving profits principally from the ownership, sale or rental of real estate or from the manufacture, sale or use of tangible personal property, such proportion of its entire net income as the fair cash value of its real estate and tangible personal property, in this State, on the date of the close of the fiscal year of such Company in the income year is to be the fair cash value of its entire real estate and tangible personal property then owned by it, with no deduction on account of incumbrances thereon.

In case of a corporation deriving profits principally from the holding or sale of intangible property such proportion as its gross receipts in this State for the year ended on the date of the close of

its fiscal year next preceding is to its gross receipts for such year within and without the State.

"Section 202. Railroads and public service corporations.—

"The basis of ascertaining the net income of every corporation engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the Standard Classification of Accounting of the Interstate Commerce Commission, shall be the 'net operating income' of such corporations as shown by their records kept in accordance with that Standard Classification of Accounts, when their business is wholly within this State and when their business is in part within and in part without this State, including in their gross 'operating revenues' within this State the equal mileage proportion within this State of their interstate business and deducting from their gross 'operating revenues' the proportionate average of operating expenses' or 'operating ratio', for their whole business, as shown by the Interstate Commerce Commission Standard Classification of Accounts. From the net operating income thus ascertained shall be deducted 'uncollectible revenue' and taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes, and the balance shall be deemed to be their net income taxable under this Act."

The foregoing section relating to the basis of ascertaining the net income of railroads was supplemented by Chapter 35 of the Public Laws of 1921, as follows:

"Sec. 1. That in determining the taxable income of a corporation engaged in the business of operating a railroad under section two hundred and two of the act to raise revenue, in the case of a railroad located entirely within this State, the net operating income shall be increased or decreased to the extent of any credit or debit balance received or paid, as the case may be, on account of car hire; and when any railroad is located partly within and partly without this State, then said net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid, as the case may be, on account of car hire."

101 Section 203 of the Income Tax Act of 1921, as amended by Chapter 35, Public Laws of 1921, is as follows:

"Section 203. Such tax shall first be levied, collected and paid in the year 1922, and with respect to the net income received during the calendar year 1921, and annually thereafter."

Section 3 of Chapter 34, Public Laws of 1921, provides:

"No tax on any property in the State shall be levied for any of the uses of the State Government. The taxes hereinafter levied in

this act are for the expenses of the State Government, the appropriations to its educational, charitable and penal institutions, pensions for Confederate Soldiers and widows, the interest on the debt of the State, an equalizing fund for public schools, and other specific appropriations made by law, and shall be collected and paid into the general fund of the State Treasurer."

"Section 306. Deductions.—

"In computing net income there shall be allowed as deductions:

"1. All the ordinary and necessary expenses paid during the income year in carrying on any trade or business, including:

"(a) As to individuals, wages of employees for services actually rendered in producing such income.

"(b) As to partnerships, wages of employees and a reasonable allowance for co-partners or members of a firm, for services actually rendered in producing such income, the amount of such salary allowance to be included in the personal return of the co-partner receiving same.

"(c) As to corporations, wages of employees and salaries of officers, if reasonable in amount, for services actually rendered in producing such income.

"2. Rentals or other payments required to be made as a condition of the continued use or possession, for the purposes of the trade of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

"3. All interest paid during the income year on indebtedness except interest on obligations contracted for the purchase of non-taxable securities. Dividends on preferred stock shall not be deducted as interest.

"4. Taxes for the income year, except taxes on income and war profits, and excess profits taxes, inheritance taxes, and taxes assessed for local benefit of a kind tending to increase the value of the property assessed.

102 "5. Dividends from stock in any corporation the income of which shall have been assessed and the tax on such income paid by the corporation under the provisions of this Act: Provided, that when only part of the income of any corporation shall have been assessed under this act, only a corresponding part of the dividends received therefrom shall be deducted.

"6. Losses sustained during the income year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit.

"7. Debts ascertained to be worthless and charged off within the income year, if the amount has previously been included in gross income in a return under this act.

"8. A reasonable allowance for the depreciation and obsolescence of property used in the trade or business; and, in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion: Provided, that in computing the deductions allowed under this paragraph, the basis shall be the cost (including in the case of mines, oil and gas wells, and other natural deposits, the cost of development, not otherwise determined) and in the case of property acquired prior to January 1, 1921, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date. The reasonable allowances under this paragraph shall be made under rules and regulations to be prescribed by the Tax Commission. In the case of leases the deductions allowed may be equitably apportioned between the lessor and lessee.

"9. In the case of taxpayers who keep regular books of account, upon an accrual basis and in accordance with standard accounting practice, reserves for bad debts and for contingent liabilities, under such rules and restrictions as the Tax Commission may impose. If the Tax Commission shall, at any time, deem the reserve excessive in amount, it may restore such excess to income, either in a subsequent year or as a part of the income of the income year and assess it accordingly.

"10. Contributions or gifts made within the taxable year to corporations or associations operated exclusively for religious, charitable, scientific or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which enures to the benefit of any private stockholder or individual, to an amount not in excess of fifteen per centum of the taxpayer's net income as computed without the benefit of this subdivision.

"11. Resident individuals having an established business in another State, or investment in property in another State, may deduct the net income from such business or investment, if such business or investment is in a State that levies a tax upon such net income. The deductions authorized in this subsection shall in no case extend to any part of income or resident individuals from personal services or mortgages, stocks, bonds, securities and deposits.

103 "12. In the case of a non-resident individual, the deductions allowed in this section shall be allowed only if, and to the extent that, they are connected with income arising from sources within the State; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the State shall be determined under rules and regulations prescribed by the State Tax Commission.

Complainant is engaged in operating an interstate railroad and keeps its accounts in accordance with the Standard Classification of Accounts prescribed by the Interstate Commerce Commission and is required to pay an income tax under the appropriate part of Section

202 of the Income Tax Act or suffer the penalties prescribed in said Act.

Complainant respectfully shows the Court that the said Act is void as to complainant for the following reasons:

(a) Article 5, Section 3 of the Constitution of North Carolina authorizes the levy of a tax upon net incomes, and the statutory method prescribed in Section 202 for complainant and like corporations in order to arrive at net income results in the tax being levied on a sum which is not in truth and in fact net income, but includes a part of complainant's operating revenue in this:

Section 202 provides that railway corporations in the class of complainant shall first arrive at gross operating revenue within the State of its interstate business, and from this gross revenue shall deduct the following items:

(1) Proportionate average of operating expenses, as shown by the Interstate Commerce Commission Standard Classification of Accounts.

(2) Uncollectible revenue.

(3) Taxes paid in North Carolina for the income year, other than taxes and war profits and excess profits taxes.

(4) An equal proportion of car hire.

Plaintiff alleges that defendants, unless restrained by order of this Court, will, pursuant to the provisions of the Statutes in force in the State of North Carolina, levy upon and assess against it the income taxes for the year 1922 and certify such levy and assessment to the officers charged with the enforcement and collection thereof, amounting to a large sum in excess of \$3,000.00 to-wit, the sum of \$19,616.46, whereas plaintiff avers that if it is allowed the deductions to which it is entitled it would not have any taxable income because the sum of such deductions is greater than its gross income, and that unless said taxes are paid within the time fixed by the Statute, plaintiff will be subjected to heavy penalties and that the levy of such taxes will constitute a lien upon its property and thereby a cloud upon its title thereto, and that plaintiff will suffer other and irreparable damage, etc., all of which will appear by reference

104 to the allegations set out in its bill herein. The plaintiff's bill seeking an injunction, restraining defendants in the discharge of the official duties imposed by the Statute is based upon the allegation that the sections of the Revenue Act of 1921, and especially upon those sections known as the "Income Tax Act" violate the Constitution of the State of North Carolina and of the United States for that among other reasons:

1st. The tax levied as directed by said Statute is not a tax on net incomes but is levied upon gross income, or real net operating income and hence is repugnant to the State Constitution and to the Commerce Clause of the Federal Constitution.

2nd. The classification made by Section 202 of the Act as to method of ascertainment of net income for plaintiff and other corporations within the designed class is arbitrary, without reasonable or practical basis and hence is repugnant to the Uniformity Clause, Art. 5, Sec. 3 of the State Constitution and the Equal Protection Clause of the Fourteenth Amendment to the Constitution of the United States.

That it is a violation of the State Constitution for the general property tax to be devoted to local purposes and the various exercise, privilege, franchise, license, and income taxes to be devoted to State purposes.

That the income tax is invalid because it is levied in addition to property and franchise taxes. That the method of ascertaining the taxable income of plaintiff fixed or prescribed by Sec. 202 of the Act violates the provisions of Art. 5, Sec. 3 of the State Constitution and of the Fourteenth Amendment to the Federal Constitution, for that such method is not applied to such railroads or other public service corporation which do not operate their properties but have income only from rentals paid them by other companies to whom they lease their entire properties to be operated by the lessees.

It is pertinent, in view of the questions presented by the bills and answers and the prayer for injunctive relief to note the provisions of Section 700-701 of the Income Tax Act as amended by the Act of 1921, creating the office known as Commissioner of Revenue, providing for the prescribing the procedure in applications for revision and appeal from assessments and levies of taxes against all persons or corporations having property in, or being liable for, tax in the State.

The Legislature, at its Special Session of 1921, made further provisions for refunding any taxes of any kind which have been through clerical error or misinterpretation or otherwise, collected or paid into the State Treasury in excess of the amount legally due the State and directing the State Auditor to issue his warrant for the amount so illegally collected to the person entitled thereto, upon certificate of the head of the department through which said taxes were collected

105 or his successor in the performance of the functions of that department, with the approval of the Attorney General and the Treasurer to pay the sum out of any funds in the treasury not otherwise appropriated.

Upon consideration of the bill and answer, Exhibits and evidence, it is

Adjudged and decreed that plaintiff is not entitled to have the defendants or either of them enjoined and restrained from the performance of the duties imposed upon them by the Statutes of North Carolina, relating to the administration, assessing, levying and enforcement or collection of the income tax against plaintiff. That the bill be dismissed. That defendants recover their cost to be taxed by the Clerk.

This the 7th day of November, 1922.

At Wilson, N. C.

H. G. CONNOR,

U. S. District Judge.

106

Notice of Appeal.

Filed Nov. 16, 1922.

In the District Court of the United States for the Eastern District of
North Carolina.

In Equity.

No. 450.

NORFOLK SOUTHERN RAILROAD COMPANY, Plaintiff,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.

Notice of Appeal.

To the defendants in the above-entitled action and Honorable James
S. Manning, Attorney General of North Carolina, and Frank Nash,
Assistant Attorney General, Solicitors for defendants:

You will please take notice that, on Friday, November 17th, 1922,
at 10.00 o'clock A. M., or as soon thereafter as counsel may be heard,
the above named plaintiff will apply to his Honor, Henry G. Connor,
District Judge, at the United States Court Room, Wilmington, N. C.,
for an order allowing plaintiff to appeal to the Supreme Court in
the above cause, and granting a stay of proceedings until the appeal
shall have been heard, passed upon *the* disposed of by the Supreme
Court of the United States.

NORFOLK SOUTHERN RAILROAD
COMPANY,

By W. B. RODMAN,
Solicitor.

Service accepted this 16th day of November.

JAMES S. MANNING,
*Attorney General of North Carolina
and Solicitor for Defendants.*

107

Order Granting Thirty Day Stay.

Filed Nov. 18, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 450.

NORFOLK SOUTHERN RAILROAD COMPANY

vs.

A. D. WATTS, as Commissioner of Revenue of North Carolina, and Others.

Income Tax Suit.

It is ordered that the defendants shall not proceed to enforce the collection of taxes involved in this litigation for the period of thirty days from the date of this order, to the end that complainant may take such action in the premises as it is advised to.

Dated at Wilmington, North Carolina this the 17th day of November, 1922.
H. G. CONNOR,
U. S. Judge.

108

Assignment of Errors.

Filed Nov. 27, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

NORFOLK SOUTHERN RAILROAD COMPANY, Plaintiff,

vs.

A. D. WATTS, Commissioner of Revenue, and JAMES S. MANNING, Attorney General for the State of North Carolina, Defendants.

Assignment of Errors.

The plaintiff prays an appeal from the final decree of this Court, to the Supreme Court of the United States, and assigns for error:

(1) That Schedule "D" of the said Act of the General Assembly of the State of North Carolina, Chapter 34 Public Laws of 1921, being an act entitled "An Act to Raise Revenue" ratified the 8th day of March, 1921, and the amendments and supplements thereto, and especially the said act as amended by Chapter 102 of the Pub-

lie Laws of the Extra Session, 1921, ratified the 19th day of December, 1921, and entitled "An Act to Amend Chapter 34 of the Public Laws of 1921, being an Act to Raise Revenue, relative to privilege tax and the Income Tax on Railroads," is in contravention of the Constitution of the United States, especially of the interstate commerce clause, section 8, article I; of section 2 article IV; of Section 1 article XIV.

(2) That the said Act is in contravention of the Constitution of the State of North Carolina, especially of section 3 article V.

(3) That said Act does not provide a method for the taxation of income of the complainant as required by the Constitution of the State, or by uniform rule as compared with the income of
109 other citizens, residents, persons or corporations doing business in the State of North Carolina, and subject to an income tax, but is really an attempt to enforce against Norfolk Southern Railroad Company and other interstate carriers in the State of North Carolina and of the United States, engaged in interstate commerce, the payment of a tax on account of and for the reason that this plaintiff, and other companies similarly situated, are engaged in the business of conducting and carrying on interstate commerce by attempting through an unjust, unreasonable and illegal classification to require plaintiff and other railroad companies doing business in the State of North Carolina and engaged in interstate commerce, to pay an income tax upon more than their net income, while all other tax payers are taxed upon their net income.

(4) That the assessment for income tax made by the defendant A. D. Watts, as Commissioner of Revenue, against the plaintiff was not made upon the net income of this plaintiff, but was made upon what was termed its "net operating income," while all other individuals and corporations doing business in the State of North Carolina and subject to income tax had their income tax assessed upon the basis of their net income, except corporations engaged in the business of operating steam or electric railroads, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the Standard Classification of Accounting of the Interstate Commerce Commission.

That the said assessment of the income tax made by the defendant A. D. Watts, as Commissioner of Revenue of North Carolina
110 was illegal and void, as being made upon a classification of plaintiff and other public service corporations engaged in interstate commerce and required to report to the Interstate Commerce Commission, and to keep their records in accordance with the orders of that Commission, and thereby imposed, or undertook to impose a tax upon the plaintiff by reason of the fact that it was engaged in interstate commerce, which tax is greater than would be imposed upon plaintiff if it were not engaged in such interstate commerce, and undertook to classify, for the purpose of an income tax and of

ascertaining what constituted net income, taxpayers into two classes, to-wit: Those engaged in interstate commerce in the operation of public service, as common carriers, and all other tax payers in the other class. That such classification was and is in violation and contravention of the Constitution of the United States, especially of the interstate commerce clause of section 8 article I; of section 2 article IV and of section 1 article XIV, and is in violation and in contravention of the Constitution of the State of North Carolina, especially section 3 article V thereof.

(5) That the Court erred in holding that the United States District Court was without jurisdiction to hear and determine the questions raised by the bill and answer filed in this cause.

(6) That the court erred in holding that the plaintiff was not entitled to have the defendants, or either of them, enjoined or restrained from the performance of the duties imposed upon them by the statutes of North Carolina, relative to the administration, assessing, levying and enforcement of collection of the income tax against plaintiff, and in dismissing the bill.

111 (7) That the court erred in refusing to enjoin the defendants from undertaking to enforce the collection of the assessment of income tax against the plaintiff, as made by A. D. Watts, Commissioner of Revenue.

W. B. RODMAN,
Attorneys for Plaintiff.

112 *Stipulation of Counsel as to the Record.*

Filed Dec. 2nd, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

NORFOLK SOUTHERN RAILROAD COMPANY, Plaintiff,

vs.

A. D. WATTS, Commissioner of Revenue, and JAMES S. MANNING,
Attorney General of State of North Carolina, Defendants.

It is stipulated and agreed by and between the parties to the above entitled cause that, the Clerk in making up transcript of record in this appeal on the order dismissing plaintiff's appeal and denying the injunction prayed for shall include all pleadings, orders, motions, stipulations, affidavits and exhibits constituting the entire record before the Court.

It is further stipulated that the Clerk shall use in preparing record on appeal printed copies of all such pleadings, documents, affidavits, etc. as may be furnished by the parties hereto.

W. B. RODMAN,
Solicitor for Plaintiff.
GEO. H. BROWN,
Of Counsel for Defendants.

28 day of Novb., 1922.

113 *Memorandum of Original Papers Certified Separately.*

Petition for Appeal filed November 27, 1922.

Appeal allowed Nov. 27, 1922.

Appeal Bond dated 1, 1922; penalty \$1,000.00; Obligors: Norfolk Southern Railroad Company and United States Fidelity and Guaranty Company; Conditioned for damages and costs.

Citation dated Nov. 27, 1922; service accepted by Geo. H. Brown, of Counsel for defendants, Nov. 27, 1922.

114 *Order to Transmit Record.*

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 450.

NORFOLK SOUTHERN RAILROAD COMPANY

vs.

A. D. WATTS, Commissioner of Revenue, et als.

And thereupon it is ordered by the Court here that a transcript of the record and proceedings in said suit be transmitted to the United States Supreme Court at Washington, D. C., and the same be transmitted accordingly.

S. A. ASHE,
Clerk United States District Court.

115

Clerk's Certificate.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 450.

NORFOLK SOUTHERN RAILROAD COMPANY

vs.

A. D. WATTS, Commissioner of Revenue, et als.

I, S. A. Ashe, Clerk, United States District Court, for the Eastern District of North Carolina, do hereby certify that the foregoing pages present a full, true and correct copy of the proceedings had and orders entered in that certain suit in equity pending in said Court, wherein Norfolk Southern Railroad Company is complainant and A. D. Watts, Commissioner of Revenue of North Carolina, and others, are defendants.

In testimony whereof, I have hereunto set my hand and affixed the seal of the said District Court at the Courthouse in Raleigh, State of North Carolina, this 9th day of December, 1922.

[Seal United States District Court, Eastern Dist. of N. C. at Raleigh.]

S. A. ASHE,

Clerk United States District Court.

116 In the District Court of the United States for the Eastern District of North Carolina.

NORFOLK SOUTHERN RAILROAD COMPANY, Plaintiff,

vs.

A. D. WATTS, Commissioner of Revenue, and JAMES S. MANNING, Attorney General of State of North Carolina, Defendants.

The above named plaintiff conceiving itself aggrieved by the decree dated the 7th day of November, 1922, made and entered on the 13th day of November, 1922, in the above entitled cause, does hereby appeal from said order and decree to the Supreme Court of the United States, for the reasons specified in the assignment of errors which is filed herewith, and prays that this appeal may be allowed, and that a transcript of the record, proceedings and papers upon which said order was made, duly authenticated, may be sent to the Supreme Court of the United States.

In connection with said appeal, the above named plaintiff respectfully prays the Court that it enter an order staying the hands of the defendants from collecting or attempting to collect, pending the hearing and disposal of said appeal, the taxes referred to and described in the bill filed in this cause, and which are alleged therein to be illegal and void, in that they are laid and attempted to be collected in violation of the provisions of the Constitution of the United States, and in support of said request and prayer for such stay, respectfully shows to the Court that the only way this plaintiff can have its appeal passed on and heard by the appellate court is by a stay of the hands of the defendants in their attempt to collect the said taxes, pending the appeal, that the very moment the said taxes are paid, the questions presented become moot questions and the appellate court will be deprived of its jurisdiction to hear and pass on the questions involved.

W. B. RODMAN,
Attorneys for Plaintiff.

Dated this 27th day of November, 1922.

118 [Endorsed:] #450. Equity. Norfolk Southern Railroad Co. vs. A. D. Watts et al. Petition for appeal. I certify that the within is entered and filed this day, Nov. 27, 1922. S. A. Ashe, Clerk.

119 In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 450.

NORFOLK SOUTHERN RAILROAD COMPANY, Plaintiff,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.

Order Allowing Appeal and Granting Supersedeas and Stay.

This cause coming on to be heard upon the application of plaintiff, Norfolk Southern Railroad Company, for an appeal to the Supreme Court of the United States, and for a supersedeas and order staying and restraining the collection of the income tax involved in this suit and alleged to be illegal in the complaint filed herein, until the determination of the appeal in this cause now pending in the Supreme Court of the United States, the plaintiff being represented by W. B. Rodman, its attorney, and the defendants by their attorneys, Frank Nash, Assistant Attorney General, and George H. Brown, the appeal prayed for is hereby granted, Appeal Bond in the sum of \$1,000.00 to be filed.

And the Court being of the opinion that the status quo between the parties should be preserved pending such determination of appeal by the plaintiff to the Supreme Court of the United States:

It is therefore, decreed and adjudged that defendants, their agents, servants and employees and each of them be and are hereby restrained from collection or attempting to collect from plaintiff the income tax which is the subject matter of this suit, pending the determination of the appeal by the plaintiff in this cause now pending in the United States Supreme Court.

It is further ordered and decreed that plaintiff do give bond with good and sufficient surety, in the sum of Ten Thousand Dollars, to be approved by the Judge of the United States Court for the Eastern District of North Carolina, or the Clerk of said Court, conditioned to pay to said defendants all of such income tax that may finally be determined in this cause to be legally due and payable by plaintiff to the defendants.

Dated this 27th day of November, 1922.

H. G. CONNOR,

District Judge Eastern District of North Carolina.

120 & 121 [Endorsed:] J. #450. Eq. Norfolk Southern Railroad Co. vs. A. D. Watts et —. Appeal & Granting Order allowing Supersedeas & Stay under \$10,000 Bond. I certify that the within is entered and filed this day. Nov. 27, 1922. S. A. Ashe, Clerk.

122 In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

NORFOLK SOUTHERN RAILROAD COMPANY, Plaintiff,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, and James S. Manning, Attorney General of North Carolina, Defendants.

Know all men by these presents: That we, Norfolk Southern Railroad Company, a corporation organized and existing under the laws of the State of Virginia, as principal, and United States Fidelity and Guaranty Company, as surety, are held and firmly bound unto the above named A. D. Watts, and the other defendants, in the sum of One Thousand Dollars (\$1,000.00), to be paid to the said A. D. Watts and the other defendants, their successors and assigns, to which payment, well and truly to be made, we bind ourselves and our successors jointly and severally by these presents.

Sealed with our seals this 1st day of December, 1922.

Whereas, in a suit pending in the District Court of the United States for the Eastern District of North Carolina between Norfolk Southern Railroad Company, Plaintiff, and A. D. Watts, and other defendants, a decree was rendered by said Court, denying plaintiff an

injunction as prayed for and dismissing plaintiff's bill, and the said Norfolk Southern Railroad Company having prayed and been allowed an appeal under Section 238 of the Judicial Code of the United States direct to the Supreme Court of the United States, and filed a copy thereof in the Clerk's office of the said Court, and
 123 & 124 citation having issued to said A. D. Watts, et al., citing and admonishing them to be and appear in the Supreme Court of the United States within the time required by law.

Now, the condition of the above obligation is such, that if the said Norfolk Southern Railroad Company shall prosecute its said appeal to effect, and answer all damages and costs if it fails to make its appeal good, then the above obligation shall be void, else to remain in full force and effect.

NORFOLK SOUTHERN RAILROAD
 COMPANY,

Attest: By G. R. LOYALL, *President.*

[Seal of the Norfolk Southern Railroad Company, Virginia.]

W. HAWKINS,
Secretary.

[Seal of the United States Fidelity & Guaranty Company, Incorporated 1896.]

UNITED STATES FIDELITY AND
 GUARANTY COMPANY,
 By MARGARET W. WALKER,
Attorney in Fact.

Approved this 2 day of December, 1922.

H. G. CONNOR,
United States District Judge.

125 [Endorsed:] #450. Equity. Norfolk Southern Railroad Co. vs. A. D. Watts et al. \$1,000.00 Appeal Bond. I certify that the within is entered and filed this day, Dec. 2, 1922. S. A. Ashe, Clerk.

126 In the District Court of the United States for the Eastern District of North Carolina.

NORFOLK SOUTHERN RAILROAD COMPANY, Plaintiff,

vs.

A. D. WATTS, Commissioner of Revenue, and JAMES S. MANNING, Attorney General for the State of North Carolina, Defendants.

The United States of America to A. D. Watts, as Commissioner of Revenue of North Carolina, and James S. Manning, as Attorney General of North Carolina, Greeting:

Whereas, Norfolk Southern Railroad Company has lately appealed to the Supreme Court of the United States, from a decree lately ren-

dered in the District Court of the United States for the Eastern District of North Carolina, made in favor of you, the said Norfolk Southern Railroad Company having filed the security required by law, you are therefore hereby cited to appear before the said Supreme Court at the City of Washington on the 27 day of December next, to do and receive what may appertain to justice to be done in the premises.

Given under my hand at the City of Raleigh in the Fourth Circuit, this the 27 day of November, in the year of our Lord, One Thousand Nine Hundred and Twenty-two.

H. G. CONNOR,
*Judge of the District Court of the United
States for the Eastern District of North
Carolina.*

I certify that the within is entered and filed this day Nov. 27, 1922.
S. A. ASHE,
Clerk.

Service accepted this Nov. 27, 1922.
GEO. H. BROWN,
Of Counsel for Defendants.

127 [Endorsed:] (J.) #450. Eq. Norfolk Southern Railway Co. vs. A. D. Watts et —. Citation & Acceptance of Service. I certify that the within is entered and filed this day, Nov. 27, 1922. S. A. Ashe, Clerk.

Endorsed on cover: File No. 29,277. Eastern North Carolina D. C. U. S. Term No. 727. Norfolk Southern Railroad Company, appellant, vs. A. D. Watts, Commissioner of Revenue, and James S. Manning, Attorney General of the State of North Carolina. Filed December 11, 1922. File No. 29,277.



Office Supreme Court, U. S.

FILED

MAR 19 1923

WM. R. STANSBURY
CLERK

IN THE
Supreme Court of the United States

OCTOBER TERM, 1922.

No. 744.

SEABOARD AIR LINE RAILWAY
COMPANY, Appellant,

vs.

A. D. WATTS, INDIVIDUALLY AND AS
COMMISSIONER OF REVENUE OF
NORTH CAROLINA, ET AL., Appellees.

**Motion for Leave to Substitute R. A. Doughton,
Commissioner of Revenue of North Carolina, for
A. D. Watts, Commissioner of Revenue of North
Carolina.**

JAMES F. WRIGHT,
MURRAY ALLEN,
Attorneys for Appellant.

March 19, 1923.

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IN THE
Supreme Court of the United States

OCTOBER TERM, 1922.

No. 744.

SEABOARD AIR LINE RAILWAY
COMPANY, Appellant,

vs.

A. D. WATTS, INDIVIDUALLY AND AS
COMMISSIONER OF REVENUE OF
NORTH CAROLINA, ET AL., Appellees.

Comes the Appellant, Seaboard Air Line Railway Company, and moves the Court to substitute R. A. Doughton as one of the Appellees in this cause in place of A. D. Watts, and, for grounds of said motion, respectfully shows:

A. D. Watts, individually and as Commissioner of Revenue of the State of North Carolina, together with James S. Manning, Attorney General of North Carolina, were the original defendants herein. A. D. Watts resigned the office of Com-

missioner of Revenue on January 29, 1923, and was on January 29, 1923, succeeded in office by R. A. Doughton, who now holds said office.

Wherefore, Appellant prays that R. A. Doughton be substituted for A. D. Watts.

JAMES F. WRIGHT,
MURRAY ALLEN,
Attorneys for Appellant.

The undersigned, James S. Manning, Attorney General of the State of North Carolina, and representing R. A. Doughton, the present Commissioner of Revenue of North Carolina, consents for said R. A. Doughton to the substitution hereinabove moved for.

JAMES S. MANNING,
Attorney for R. A. Doughton.

FILED

MAR 19 1923

WM. R. STANSBURY
CLERK

IN THE
Supreme Court of the United States

OCTOBER TERM, 1922.

No. 727.

NORFOLK SOUTHERN RAILROAD
COMPANY, Appellant,
vs.

A. D. WATTS, INDIVIDUALLY AND AS
COMMISSIONER OF REVENUE OF
NORTH CAROLINA, ET AL., Appellees.

**Motion for Leave to Substitute R. A. Doughton,
Commissioner of Revenue of North Carolina, for
A. D. Watts, Commissioner of Revenue of North
Carolina.**

W. B. RODMAN,
Counsel for Appellant.

March 19, 1923.



IN THE
Supreme Court of the United States

OCTOBER TERM, 1922.

No. 727.

NORFOLK SOUTHERN RAILROAD
COMPANY, Appellant,

vs.

A. D. WATTS, INDIVIDUALLY AND AS
COMMISSIONER OF REVENUE OF
NORTH CAROLINA, ET AL., Appellees.

Comes the Appellant, Norfolk Southern Railroad Company, and moves the Court to substitute R. A. Doughton as one of the Appellees in this cause in place of A. D. Watts, and, for grounds of said motion, respectfully shows:

A. D. Watts, individually and as Commissioner of Revenue of the State of North Carolina, together with James S. Manning, Attorney General of North Carolina, were the original defendants herein. A. D. Watts resigned the office of Com-

missioner of Revenue on January 29, 1923, and was on January 29, 1923, succeeded in office by R. A. Doughton, who now holds said office.

Wherefore, Appellant prays that R. A. Doughton be substituted for A. D. Watts.

W. B. RODMAN,
Attorney for Appellant.

The undersigned, James S. Manning, Attorney General of the State of North Carolina, and representing R. A. Doughton, the present Commissioner of Revenue of North Carolina, consents for said R. A. Doughton to the substitution hereinabove moved for.

JAMES S. MANNING,
Attorney for R. A. Doughton.

FILED
MAR 19 1923
WM. R. STANSB
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IN THE
Supreme Court of the United States
OCTOBER TERM, 1922

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No. 727
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NORFOLK SOUTHERN RAILROAD COMPANY,
Appellant,
against

A. D. WATTS, COMMISSIONER OF REVENUE, AND
JAMES S. MANNING, ATTORNEY GENERAL OF
THE STATE OF NORTH CAROLINA,
Appellees.

—
BRIEF ON BEHALF OF APPELLANT
—

W. B. RODMAN, *Counsel.*

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IN THE
Supreme Court of the United States

OCTOBER TERM, 1922

No. 727

NORFOLK SOUTHERN RAILROAD COMPANY,
Appellant,
against

A. D. WATTS, COMMISSIONER OF REVENUE, AND
JAMES S. MANNING, ATTORNEY GENERAL OF
THE STATE OF NORTH CAROLINA,
Appellees.

BRIEF ON BEHALF OF APPELLANT

STATEMENT OF CASE

Plaintiff, a Virginia corporation, operating a line of railroad, situate in the states of Virginia and North Carolina, filed its bill in the District Court of the United States for the Eastern District of North Carolina, against A. D. Watts, Commissioner of Revenue, and James S. Manning, Attorney General of the State (who, under the laws of the State, are charged with the duty of collecting income taxes authorized by Schedule D, Chapter 34, Public Laws, 1921, as amended), seeking to have the collection of the tax assessed against plaintiff enjoined upon the ground that the statute and the assessment of the tax against plaintiff made thereunder are illegal and void, as being in contravention of the Constitution

of the United States, Article 1, Section 8 (the Commerce Clause), the XIV Amendment, and the State Constitution, Article V, Sec. 3.

Plaintiff asked for a restraining order, pending final hearing, it being inconvenient for three judges to assemble, as required by Sec. 266 of the Judicial Code, by consent the cause was set down for final hearing upon complaint, answer, and affidavits.

From a final decree, dismissing the bill, plaintiff appealed direct to this Court, under the provisions of Sec. 238 of the Judicial Code.

STATEMENT OF QUESTIONS INVOLVED

The power of the State to tax the "net income" of plaintiff is not denied; that power is admitted.

The pleadings admit, if plaintiff is allowed to deduct from its gross income the same items of expense and losses as are allowed all other tax payers, plaintiff has no income subject to taxation.

(Section 17 of Complaint and Answer.)

The questions involved are two:

(1) The power of the State to tax, the revenues which plaintiff receives from the operation of its railroad property in interstate commerce, after deducting therefrom the cost of operation, uncollectable railway revenue, and taxes, increasing or decreasing this balance by the credit or debit balance of its car hire account.

(2) The power of the State to classify income tax payers based upon the manner in which they are required to keep their records.

ASSIGNMENTS OF ERROR

The assignments of error are set out in full in Appendix A.

Briefly, they are, that the statute authorizing the tax, and

the assessment of the tax, is illegal, as being in contravention of the Constitution of the United States, for that :

(1) They are in contravention of Article 1, Sec. 8 of the Constitution of the United States (the commerce clause).

(2) They are in contravention of the XIV Amendment to the Constitution of the United States.

(3) They are in contravention of the Constitution of the State, Article V, Sec. 3.

(4) That the Court erred in denying the injunction and dismissing the bill.

ARGUMENT

PART I

JURISDICTION

The appropriate and necessary averments as to diversity of citizenship and amount in controversy are made and not denied; privileges and immunities under the Constitution of the United States are set up and alleged to be violated.

The answer denies that this is a suit in equity arising under the Constitution and laws of the United States, and denies that matters are involved arising under the Constitution and laws of North Carolina.

The bill alleges and the answer admits that the law which is attacked undertakes to classify corporations for the purpose of ascertaining the deductions which corporations may make from their gross income in order to ascertain their net income subject to taxation. (Section 26 of bill and answer.)

It is alleged that this classification is arbitrary and without any real foundation, having no fair or substantial relation to the proper object sought to be accomplished by the legislation, and that the result of such classification is to unduly burden and regulate interstate commerce, that this violates the commerce clause and the Fourteenth Amendment of the Federal Constitution as well as the Constitution of the State.

That this raises questions under the Federal Constitution as well as under the State Constitution cannot be denied.

Jurisdiction exists on the ground of diverse citizenship, as well as that a Federal question is involved.

UNDER THE STATE STATUTES, A COURT OF EQUITY IS AUTHORIZED TO ENJOIN, BOTH PENDENTE LITE AND UPON FINAL HEARING, THE COLLECTION OF A TAX ALLEGED TO BE ILLEGAL AND VOID, AND TAX PAYER IS NOT REQUIRED TO PAY THE TAX AND SUE AT LAW TO RECOVER IT BACK, ALTHOUGH HE MAY DO SO.

Consolidated Statutes, Sec. 7979:

"Unless a tax or assessment, or some part thereof, be illegal or invalid, or be levied or assessed for an illegal or unauthorized purpose, no injunction shall be granted by any court or judge to restrain the collection thereof in whole or in part, nor to restrain the sale of any property for the nonpayment thereof; nor shall any court issue any order in claim and delivery proceedings or otherwise for the taking of any personalty levied on by the sheriff to enforce payment of such tax or assessment against the owner thereof. Whenever any person shall claim to have a valid defense to the enforcement of a tax or assessment charged or assessed upon his property or poll, such person shall pay such tax or assessment to the sheriff; but, if, at the time of such payment, he shall notify the sheriff in writing that he pays the same under protest, such payment shall be without prejudice to any defenses or rights he may have in the premises, and he may at any time within thirty days after such payment, demand the same in writing from the treasurer of the State or of the county, city or town, for the benefit or under the authority or by request of which the same was levied; and if the same shall not be refunded within ninety days thereafter, may sue such county, city or town for the amount so demanded, including in his action against the county both state and

county tax; and if upon the trial it shall be determined that such tax or any part thereof was levied or assessed for an illegal or unauthorized purpose, or was for any reason invalid or excessive, judgment shall be rendered therefor, with interest, and the same shall be collected as in other cases. The amount of State taxes for which judgment shall be rendered in such action shall be refunded by the state treasurer."

In *Sherrod v. Dawson*, 154 N. C., 525-529, the Court had before it the question of the proper remedy in a contest over the validity of a tax alleged to be illegal, and on pages 528-529 said:

"An injunction will lie to restrain the collection of taxes and to restrain the sale of property under distraint, for three reasons, to-wit: (1) If the taxes or any part thereof be assessed for an illegal or unauthorized purpose. (2) If the tax itself be illegal or invalid. (3) If the assessment of the tax be illegal or invalid. Revisal, sections 821 and 2855. *Purnell v. Page*, 133 N. C., 125.

"In the case of *Lumber Co. v. Smith*, 146 N. C., 199, which was an action brought to collect taxes on solvent credits, Justice Connor, writing the opinion of the court for an undivided bench, held that injunction is the proper remedy as against delinquent taxes illegally sought to be collected. Upon the same point see, also, *Armstrong v. Stedman*, 130 N. C., 217; *Ins. Co. v. Stedman*, 130 N. C., 221.

"In this case the injunctive relief sought is not merely ancillary to the principal relief demanded in the action, but is itself a main relief, for, assuredly, as to one or the other county, the tax is illegal and invalid.

"In the case of *Hyatt v. DeHart*, 140 N. C., 270, this Court held that it is the general rule that the Court will not dissolve an injunction where the main relief demanded in the action is injunctive.

"In *Purnell v. Page*, 133 N. C., 129, the present Chief Justice spoke for the Court in these words: 'As to the other point, whether the plaintiff can maintain an injunction against the sale of his property under an illegal tax, or must pay the tax under protest and sue to recover it back, it is equally well settled that he can pursue either remedy. *Range Co., v. Carver*, 118 N. C., 331; *Armstrong v. Stedman*, 130 N. C., 217; *Brinkley v. Smith*, 130 N. C., 224, hold that under the language of the statute injunctive relief may be invoked by a tax payer when the tax is invalid or illegal.'"

AN ENLARGEMENT OF EQUITABLE RIGHTS
ARISING FROM THE STATUTES OF A STATE MAY
BE ADMINISTERED BY THE UNITED STATES
COURTS.

In *Smyth v. Ames*, 169 U. S., 466, 516, 517, the Court says:

"One who is entitled to sue in the Federal Circuit Court may invoke its jurisdiction in equity whenever the established principles and rules of equity permit such a suit in that Court; and he cannot be deprived of that right by reason of his being allowed to sue at law in a State Court on the same cause of action. It is true that an enlargement of equitable rights arising from the statutes of a state may be administered by the Circuit Courts of the United States. Case of *Frederick's Will*, 88 U. S., 503, 520; *Holland v. Challen*, 110 U. S., 15-24; *Dick v. Foraker*, 155 U. S., 404; *Borden v. Land & River Improvement Co.*, 157 U. S., 327, 330; *Rich v. Braxton*, 158 U. S., 375, 405. But if the case in its essence be one cognizable in equity, the plaintiff—the required value being in dispute—may invoke the equity powers of the proper Circuit Court of the United States whenever jurisdiction attaches by reason of diverse citizenship, or upon any other ground of Federal jurisdiction. *Payne v. Hook*, 74 U. S., 425, 430; *Mc-*

Conshay v. Wright, 121 U. S., 201, 205. A party, by going into a national court, does not, this Court has said, lose any right or appropriate remedy of which he might have availed himself in the State courts, in the same locality; that the wise policy of the Constitution gives him a choice of tribunals. *Davis v. Gary*, 83 U. S., 203, 221; *Crowley v. Northern Pacific Railroad Co.*, 159 U. S., 569, 583. So wherever a citizen of a state can go into the courts of a state to defend his property against the illegal acts of its officers, a citizen of another state may invoke the jurisdiction of the federal courts to maintain a like defense. A state cannot tie up a citizen of another state, having property rights within its territory, invaded by unauthorized acts of its own officers, to suits for redress in its own courts. *Reagan v. Farmers Loan & Trust Co.* (No. 1), 154 U. S., 362, 291; *Mississippi Mills v. Cohn*, 150 U. S., 202, 204; *Cowles v. Mercer County*, 74 U. S., 118; *Lincoln County v. Luning*, 133 U. S., 529; *Scott v. Neeley*, 140 U. S., 106; *Chicot County v. Sherwood*, 148 U. S., 529; *Cates v. Allen*, 149 U. S., 451."

Under the statutes of the State, as the Supreme Court of the State says, it is well settled that where a tax is attacked as being illegal, it need not be paid and suit brought for its recovery back, but its collection may be enjoined.

It is equally as well settled that plaintiff, a non-resident, may pursue in the federal courts the same remedies he could in the state courts.

The property of complainant may be sold if the tax be not paid within sixty days from the date it becomes due, see Sec. 504. (Appendix, page--).

The Supreme Court of the State reviewed this statute as to the power to tax the salary of judges, in *Long v. Watts* (N. C.), 110 S. E., 765.

REMOVAL OF A CLOUD FROM THE TITLE TO PROPERTY IS A WELL RECOGNIZED RULE OF EQUITABLE JURISDICTION.

In *Shaffer v. Carter*, 252 U. S., 37-51, a suit to enjoin the collection of a state income tax upon the ground that it was illegal, the court considering the question of jurisdiction of the Federal Court, where the state statute gave the tax payer a right to appeal from the decision of the commissioner of revenue, and have all matter complained of reviewed and adjusted to the extent that justice might demand, the Court, on page 48, says:

"The procedure prescribed by paragraph 11 of the Income Tax Law for enforcing such a tax by imposing a lien upon the tax payer's entire property, as threatened to be put into effect against plaintiff's property, for taxes not assessed against the property itself, and not confined to the income that proceeded from the same property, is not 'due process of law,' within the requirements of the Fourteenth Amendment. For removal of a cloud upon title caused by an invalid lien imposed for a tax valid in itself, there appears to be no legal remedy. Hence, on this ground at least, resort was properly had to equity for relief; and since a court of equity does not 'do justice by halves,' and will prevent, if possible, a multiplicity of suits, the jurisdiction extends to the disposition of all questions raised by the bill. *Camp v. Boyd*, 229 U. S., 530, 551, 552; *McGowan v. Parish*, 237 U. S., 285, 296."

Wherefore, we respectfully submit that the Court has jurisdiction of all matters which may arise during the controversy.

PART II ANALYSIS OF STATUTE

The statute, as amended and in force, is set out in full as Appendix B.

Sections 200, 201 and 202 classify tax payers, prescribe the

rate of taxation, the method of apportioning the "net income" of individuals and corporations, between states, where the income is derived from a business done in more than one state.

No contention is made that the method of apportioning the "net income" derived from business conducted in two or more states is illegal, as in that respect, especially as to industrial corporations, the statute follows the rule approved in *Underwood Typewriter Company v. Chamberlain*, 254 U. S., 113.

Sections 200 and 201 prescribe the rate of taxation applicable to individuals and corporations. Sections 201 and 202 classify corporations, while sections 202 and 300 to 307 define what constitutes "net income," of the different classes, which is the subject of taxation under the act.

Section 202 "RAILROADS AND PUBLIC SERVICE CORPORATIONS:

"The basis of ascertaining the net income of every corporation engaged in the business of operating a steam or electric railroad, express service, when such company is required to keep records according to the Standard Classification of Accounting of the Interstate Commerce Commission, shall be the 'net operating income' of such corporations as shown by their records kept in accordance with that standard classification of accounts, when their business is wholly within this State, and when their business is in part within and in part without the State, their net income within this State shall be ascertained by taking their gross 'operating revenues' within this State, including in their gross 'operating revenues' within this State the equal mileage proportion within this State of their interstate business and deducting from their gross 'operating revenues' the proportionate average of 'operating expenses,' or 'operating ratio,' for their whole business, as shown by the Interstate Commerce Commission Standard Classification of Accounts. From the net operating income thus ascertained shall be deducted 'uncollectable revenue' and

taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes, and the balance shall be deemed to be their net income taxable under this act."

This section defines :

- (a) To what class of corporations it is applicable.
- (b) What shall constitute their "net income" subject to taxation, how it is to be ascertained.
- (c) How it is to be apportioned, when the business is carried on in more than one State.

A. CLASS OF CORPORATIONS, SECTION 202, APPLIES ONLY TO THOSE ENGAGED IN INTER-STATE COMMERCE.

This section is applicable only to those corporations "engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the Standard Classification of Accounting of the Interstate Commerce Commission."

There is no law of the State which requires corporations doing business in the State to keep records in any special manner. The only law requiring corporations to keep records "according to the Standard Classification of Accounting of the Interstate Commerce Commission" is the Act of Congress commonly called the Interstate Commerce Act.

The only corporations subject to the provisions of the Interstate Commerce Act are those engaged as common carriers in interstate or foreign commerce of:—

- (a) The transportation of passengers or property wholly by railroad, or partly by railroad and partly by water, when both are used under a common control, management, or arrangement for a continuous carriage or shipment; and,
- (b) The transportation of oil or other commodity, except water, and except natural or artificial gas, by pipe line, or partly by pipe line and partly by railroad or water; and,

(c) The transportation of intelligence by wire or wireless.

The act expressly states that it does not apply to corporations engaged in intrastate commerce alone.

Interstate Commerce Act, Sec. 1 (1).

The decisions of the courts are to the same effect.

State of Texas v. Eastern Texas R. R. Co. (U. S. S. Ct. decided March 13, 1922.)

Village of Hubbard, Ohio, v. U. S., 278 Fed., 254.

The basis of the classification, therefore, is:

(1) Corporations engaged as common carriers in foreign or interstate commerce by railroad, pipe line of certain commodities, and the transmission of intelligence by wire or wireless.

(2) All other corporations and tax payers.

Under the laws of North Carolina, corporations owning lines of railroad used chiefly or largely in hauling logs and other commodities, the property of the corporation, upon application to the State Corporation Commission, may obtain a permit to become common carriers, and may limit the character of service to be performed.

Consolidated Statutes, Sec. 3413.

It is not denied that there are in the State a number of corporations which own railroads of standard gauge, operated by steam, which have applied for and obtained authority to act as limited common carriers; that these corporations have filed tariffs of charges with the State Corporation Commission as required by law; that they are supervised by the State Corporation Commission to prevent discrimination. That these corporations are to be governed by the same rules in relation to the public and their employees as steam railroads engaged as common carriers generally, is well settled.

Stewart vs. Railroad, 146 N. C., 47, 49.

Bird v. Leather Co., 143 N. C., 283.

Hemphill v. Lumber Company, 141 N. C., 487.

Wright v. Railroad, 151 N. C., 529.

Blackburn v. Lumber Co., 152 N. C., 361.

It is not denied that these limited common carriers, although engaged in operating standard gauged railroads, have not filed tariffs with the Interstate Commerce Commission, and are not engaged in interstate or foreign commerce, and are not required to keep records according to the Standard Classification of Accounting prescribed by the Interstate Commerce Commission.

The classification, then, for the purpose of defining what constitutes "net income" subject to taxation under the act, is:

(1) Common carriers by railroad, by pipe line of certain classes of commodities, and of transmission of intelligence, when engaged in interstate or foreign commerce.

(2) Common carriers by railroad, by pipe line, and of intelligence, when engaged in intrastate commerce, and all other corporations and individuals.

So that the basis of classification is not the fact of being a railroad or other public service corporation, but whether the business is interstate or foreign commerce or intrastate commerce.

B. DEFINITION OF WHAT CONSTITUTES NET INCOME SUBJECT TO TAXATION, OF THE TWO CLASSES.

(1) THOSE ENGAGED IN INTERSTATE OR FOREIGN COMMERCE BY RAILROAD, PIPE LINE OR THE TRANSMISSION OF INTELLIGENCE.

This class is controlled by Sec. 202, which says the "net income" subject to taxation shall be the "net operating income" of such corporations as shown by their records kept in accordance with that standard of classification of accounts, when their business is wholly within the State, and when their business is part within and part without the State, their net income within this State shall be ascertained by taking their gross

"operating revenues" within this State, including in their gross "operating revenues" within this State the equal mileage proportion within the State of their interstate business, and deducting from their gross "operating revenue" the proportionate average of "operating expenses" or "operating ratio" for their whole business, as shown by the Interstate Commerce Commission Standard Classification of Accounting. From the net operating income thus ascertained shall be deducted "uncollectible revenue" and taxes paid in this State for the income year, other than income and war profits and excess profits taxes, and the balance shall be deemed to be their net income taxable under this act.

By Chapter 35 of the Public Laws, 1921 (see Appendix B), this was to be increased or decreased by the whole, where the road is situate entirely within the State, and by a mileage proportion where the road is located partly within and partly without the State, of any credit or debit of what is known as the car hire account.

As the statute, in defining what constitutes "net income" subject to taxation for this class of tax payers, refers to operating revenues as shown by records kept according to the rules of the Interstate Commerce Commission, it becomes necessary to examine those rules.

The rules of the Interstate Commerce Commission providing how records of common carriers by railroad, subject to the act, shall be kept, divides their accounts of revenue and expense into two classes:

- (1) Operating revenues and operating expenses; and,
- (2) Income, profit and loss, and general balance sheet accounts.

As to the first class, "operating revenue" and "operating expenses," which the statute refers to, the orders of the commission, among others, provide:

- (1) "Operating Accounts.—The accounts of this classification are designed to show the revenues and expenses (including the maintenance of the facilities used) of the carrier's railway

operations, including rail-line transportation, water transportation, if any, and services incident to transportation. Transportation includes the receipt, conveyance and delivery of traffic."

(Pr. R., page 53.)

(2) (1) of special instructions.

Accounts for Operating Revenues—"The accounts provided for operating revenues are designed to show the amounts of money which a carrier becomes entitled to receive from transportation and from the operations incident thereto." (Pr. R., page 53.)

(3) Operating Expenses—"The accounts prescribed for operating expenses are designed to show expenses of furnishing transportation services, including the expense of maintaining the plants used in the service." (Pr. R., page 54.)

The rules of the commission further provide:

"Miscellaneous Operations: The revenue and expenses of miscellaneous operations, involving the use of such facilities as hotels and restaurants, power plants, cold storage plants, cotton compresses, wood preserving plants, ice supply plants, etc., shall not be included in the accounts of the classification when the facilities used are distinct from those used by the carrier in the service of transportation or in the maintenance of facilities used in transportation service, and the operations are not incident to such service."

It is manifest, therefore, that under a system of records kept according to the rules and orders of the Interstate Commerce Commission, the terms "operating revenues," "gross operating revenues," "operating income," "expenses" and "net operating revenues" all relate solely to that revenue and expense of the carrier which is derived from and necessary to carry on transportation, and, when limited to common carriers engaged in interstate or foreign commerce, those terms relate to revenues and expenses arising from or made in the carrying

on of interstate commerce, and exclude all other classes of revenue and expenses except those derived from transportation.

The second class of accounts, those designated "income, profit and loss, and general balance sheet accounts," deal with the gross revenues and expenses arising not only from conducting transportation, but from all sources.

As to this class of accounts, the order of the Commission provides:

"Income accounts are those designed to show as nearly as practicable, for each fiscal period, the total amount of money that a carrier becomes entitled to receive for services rendered, the returns accrued upon investments, the accrued costs paid or payable for services rendered by it, the losses sustained by it, the amounts accrued for taxes, for use of money and for the use of properties of others, and the appropriations made from income during the period. The net balance of income (or loss) shall be carried to 'profit and loss.'"

This net balance is the true "net income" of the carriers. It is admitted plaintiff had none for the tax year under consideration.

Under this system of accounting, the term "net operating income" or gross operating income less operating expenses, excludes from gross income all gain from:

- (a) Rents of facilities owned by this company and used jointly with it by another or other carriers.
- (b) Rent from property not used for common carrier purposes.
- (c) Receipts from the use of non-operating physical property.
- (d) Interest upon bonds and dividends upon stocks owned.
- (e) Gain or profits from the sale or conversion of capital assets.

There is also excluded all rents paid for property used in the business and necessary for the continuation of the business, where no title is taken thereto; interest paid, whether on funded

or unfunded debts; discounts or amortization of debts, and any and all other losses and expenses, unless arising out of the carrying on of transportation.

Of course, car hire is excepted, as that is taken from the income account and charged or allowed as it is a credit or a debit balance.

If income be as defined in *Eisner v. McComber*, 252 U. S., 189, 207, "The gain derived from capital, from labor or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets," it is manifest that the statute was not designed to, and does not, deal with or tax plaintiff's income, but only undertakes to tax that portion of its revenues derived from the transportation of passengers and property in interstate, foreign and intrastate commerce, less certain items of expense.

If the term "net income" be the same as "net earnings," and it be given the definition given the latter term in *St. John v. Erie Railway Company*, 98 U. S., 136, 147, 148, where Mr. Justice Sawyer, for the Court, says: "The preferred dividends were to be paid out of the 'net earning of the road.' The lexical definition of 'net' is 'clear of all charges and deductions,' Webster; 'that which remains after deductions of all charges or outlays, as net profits,' Worcester. The popular acceptance of the term is the same."

It is clear that the tax is not laid upon the "net income" of the plaintiff, and does not deal with its income, but only revenue and expenses from transportation; so that plaintiff and others in its class are taxed not upon income or net income, but upon revenues from transportation, less certain items of expense allowed as deductions.

(2) THOSE COMMON CARRIERS BY STEAM RAILROAD, BY PIPE LINE AND IN THE TRANSMISSION OF INTELLIGENCE, ENGAGED SOLELY IN INTRASTATE COMMERCE, TOGETHER WITH ALL OTHER TAX PAYERS.

What constitutes the "net income" subject to taxation of this

class is the difference between their gross income, as set out in Sec. 301, and the deductions authorized by Sec. 306.

"Sec. 301. *Gross Income Defined.* 1. The words 'gross income' include gains, profits and income derived from salaries, wages or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, trades, business, commerce or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income of the income year in which received by the taxpayer, unless, under the methods of accounting permitted under this act, any such amounts are to be properly accounted for as of a different period.

"2. The words 'gross income' do not include the following items, which shall be exempt from taxation under this act:

"(a) The proceeds of life insurance policies and contracts paid upon the death of the insured to individual beneficiaries or to the estate of the insured.

"(b) The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment or annuity contracts, either during the term or at the maturity of the term mentioned in the contract, or upon surrender of the contract.

"(c) The value of property acquired by gift, bequest, devise or descent (but the income from such property shall be included in gross income).

"(d) Interest upon the obligations of the United States or its possessions, or of the State of North Carolina.

"(e) Salaries, wages or other compensation received from the United States by officials or employees thereof,

including persons in the military or naval forces of the United States.

"(f) Any amounts received through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received, whether by suit or agreement, on account of such injuries or sickness."

This section is longer than the definition of income by this Court in *Eisner v. McCumber*, *supra*, but both cover the same ground, with the difference the statute excepts gain from sources which the State may not tax, i.e., salaries and interest paid by United States Government, and also interest on its own bonds.

"Sec. 306. *Deductions.* In computing net income, there shall be allowed as deductions:

"(1) All the ordinary and necessary expenses paid during the income year in carrying on any trade or business, including:

"(a) As to individuals, wages of employees for services actually rendered in producing such income.

"(b) As to partnerships, wages of employees and a reasonable allowance for copartners or members of a firm, for services actually rendered in producing such income, the amount of such salary allowance to be included in the personal return of the copartner receiving same.

"(c) As to corporations, wages of employees and salaries of officers, if reasonable in amount, for services actually rendered in producing such income.

"2. Rentals or other payments required to be made as a condition of the continued use or possession, for the purpose of the trade of property to which the tax payer has not taken or is not taking title or in which he has no equity.

"3. All interest paid during the income year on indebtedness, except interest on obligations contracted for

the purchase of non-taxable securities. Dividends on preferred stock shall not be deducted as interest.

"4. Taxes for the income year, except taxes on income and war profits, and excess profits taxes, inheritance taxes, and taxes assessed for local benefit of a kind tending to increase the value of the property assessed.

"5. Dividends from stock in any corporation the income of which shall have been assessed and the tax on such income paid by the corporation under the provisions of this act: *Provided*, that when only part of the income of any corporation shall have been assessed under this act, only a corresponding part of the dividends received therefrom shall be deducted.

"6. Losses sustained during the income year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit.

"7. Debts ascertained to be worthless and charged off within the income year, if the amount has previously been included in gross income in a return under this act.

"8. A reasonable allowance for the depreciation and obsolescence of property used in the trade or business; and, in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion: *Provided*, that in computing the deductions allowed under this paragraph, the basis shall be the cost (including in the case of mines, oil and gas wells, and other natural deposits, the cost of development not otherwise deducted), and in the case of property acquired prior to January 1, 1921, the fair market value of the property (or the tax payer's interest therein) on that date shall be taken in lieu of cost up to that date. The reasonable allowances under this paragraph shall be made under rules and regulations to be prescribed by the Tax Commission. In the case of leases, the deductions allowed may be equitably apportioned between the lessor and lessee.

"9. In the case of tax payers who keep regular books of

account, upon an accrual basis and in accordance with standard accounting practice, reserves for bad debts and for contingent liabilities, under such rules and restrictions as the Tax Commission may impose. If the Tax Commission shall at any time deem the reserve excessive in amount, it may restore such excess to income, either in a subsequent year or as a part of the income of the income year, and assess it accordingly.

"10. Contributions or gifts made within the taxable year, to corporations or associations operated exclusively for religious, charitable, scientific or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, to an amount not in excess of fifteen per centum of the tax payer's net income as computed without the benefit of this subdivision.

"11. Resident individuals having an established business in another State, or investment in property in another State, may deduct the net income from such business or investment if such business or investment is in a State that levies a tax upon such net income. The deduction authorized in this sub-section shall in no case extend to any part of income of resident individuals from personal services, or mortgages, stocks, bonds, securities and deposits.

"12. In the case of nonresident individuals, the deductions allowed in this section shall be allowed only if, and to the extent that, they are connected with income arising from sources within the State; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the State shall be determined under rules and regulations prescribed by the State Tax Commission."

These deductions cover all expenses and losses of a corporation, so that what is left is that which Mr. Justice Van Deventer, in *William E. Peck & Co. v. Lowe*, 247 U. S., 165, said as

to the revenue derived from exportation of goods, could be taxed as "net income," viz: what is left "after all expenses are paid and losses adjusted, and after the recipient of the income is free to use it as he chooses."

This constitutes true "net income," and admittedly is the subject of taxation. Plaintiff admittedly has none.

Plaintiff, under the statute, is not required to report, as part of its income, money derived:

(1) From any business it may conduct except the business of transportation and its incidents;

(2) From any property which it may own, either by way of rents (except cars) or interest upon money loaned, or dividends upon stocks owned, or by sale or conversion of capital assets;

All of which are included in the definition of gross income of all other tax payers, including railroads engaged solely in intrastate commerce.

Plaintiff, under this statute, is not allowed to deduct from its gross income:

(1) Rent paid for the use of property used in its business (except car hire) and necessary to the continued carrying on of the business, and where plaintiff has not taken title, nor is taking title and has no equity in the property.

(2) The cost of conducting and carrying on any business other than that of transportation and its incidents.

(3) Interest paid for the use of money, whether funded or short term loans, irrespective of why it became necessary to incur this expense.

(4) Losses from storm, fire or otherwise, not covered by insurance, unless it be such as can be charged to the cost of conducting transportation.

All other tax payers, including those operating steam railroads in intrastate commerce, are allowed to deduct these expenses from their gross income, in order to ascertain the "net income" subject to taxation.

PART III.

THE STATUTE CONTRAVENES ARTICLE I, SEC. 8,
OF THE CONSTITUTION OF THE UNITED STATES.
(The Commerce Clause). 74

Mr. Chief Justice Fuller, speaking for the Court, in *Postal Telegraph & Cable Company v. Adams*, 155 U. S., 688, 696, says:

"It is settled that where by way of duties laid on the transportation of the subjects of interstate commerce, *or on the receipts derived therefrom*, or on the occupation or business of carrying it on, a tax is levied on interstate commerce, such a taxation amounts to a regulation of commerce and cannot be sustained." (Italics supplied).

This is cited with approval in *Crew Lerick Co. v. Pennsylvania*, 245 U. S., 292, 294, where Mr. Justice Pitney also says, we:

"Are in duty bound to determine the question raised under the Federal Constitution, upon our own judgment of the actual operation and effect of the tax, irrespective of the form it bears."

In *Galveston, H. & S. A. R. Co. v. Texas*, 210 U. S., 217, 227, Mr. Justice Holmes, for the Court, says:

"Neither the State courts, nor the Legislature, by giving the tax a particular name, or by the use of some form of words, can take away our duty to consider its nature and effect."

We have already pointed out in an analysis of the statute that the tax in question is not a tax upon plaintiff's "net income" but on the contrary is a tax upon that part of its revenue derived from transportation of passengers and commodities in foreign, interstate and intrastate commerce, after deducting therefrom the cost of conducting that transportation, uncol-

lectible railway revenue, taxes, the balance being increased or decreased as the rent of cars shows a credit or debit balance.

In *Peck Co. v. Lowe*, 247 U. S., 165, where the Court had under consideration the income tax act of the United States, which was attacked upon the ground that it was a tax upon exports from one State to another, Mr. Justice Van Devanter, for the Court said:

"The tax in question is unlike any of those heretofore condemned. It is not laid on articles in course of exportation, or on anything which inherently or by the usages of commerce is embraced in exportation or any of its processes. On the contrary it is an income tax laid generally on net incomes. And while it cannot be applied to any income which Congress has no power to tax (see *Stanton v. Baltic Mining Co.*, 240 U. S., 554) it is both nominally and actually a general tax. *It is not laid on income from exportation because of its source, or in a discriminative way, but just as it is laid on other income.* The words of the act are 'Net Income arising or accruing from all sources.' There is no discrimination. At most exportation is affected only indirectly and remotely. *The tax is levied after exportation is completed, after all expenses are paid and losses adjusted and after the recipient of the income is free to use it as he chooses.*" (Italics supplied).

The tax under attack does not come within the rule here laid down.

The tax is here laid upon the operating revenues or income of plaintiff, which are derived in part from interstate commerce. Only those corporations engaged in transportation of interstate commerce are taxed in the same way.

The tax must be paid, upon that part of plaintiff's revenue derived from interstate and intrastate commerce, which plaintiff must expend in order to continue to keep possession of those facilities which it is necessary for plaintiff to use in order to continue to carry on its business, i.e., rent of other lines of

railroad, and the joint use of the tracks and facilities of other carriers, which for the tax year 1921 as to plaintiff amounted to \$194,739.55. (See Pr. R., page 20).

The tax must be paid from revenue derived from interstate and intrastate commerce, before plaintiff can use any part of such revenue to pay interest on money borrowed to enable it to either provide the necessary facilities to carry on the business or if necessary to pay the men employed to conduct the business.

Corporations not engaged in interstate commerce, as common carriers, are not so taxed, common carriers by railroad engaged in intrastate commerce within the State, are under the statute taxed in a different manner; true they have been allowed to limit their obligations to the public, but as to those commodities which they hold themselves out as carrying their obligation and duties to the public are necessarily the same as those of the plaintiff, they are both railroad companies and both common carriers.

In what way could the Legislature more clearly indicate its will to tax plaintiff on account of or because it was engaged in interstate commerce, or because of the source from which the revenue taxed is derived.

It selects those corporations which are engaged as common carriers in interstate commerce, and taxes them upon the revenue derived from transportation, less certain deductions; it taxes all other corporations, including those engaged as common carriers by railroad in intrastate commerce in an entirely different manner to the great disadvantage of the first class.

The principle involved was discussed by Mr. Justice Brandies, who, speaking for the Court in *United States Glue Co. v. Oak Creek*, 247 U. S., 321, 328, 329, said:

"A tax upon gross receipts affects each transaction in proportion to its magnitude, and irrespective of whether it is profitable or otherwise. Conceivably it may be sufficient to make the difference between profits and loss, or so to diminish the profits as to impede or discourage the conduct of commerce. A tax upon the net profits has not

the same deterrent effect, *since it does not arise at all unless a gain is shown over and above expenses and losses*, and the tax cannot be heavy unless the PROFITS ARE LARGE. Such a tax, when imposed upon *net income from whatever source arising is but a method of distributing the cost of government, like a tax upon property or upon franchise treated as property; and if there be no discrimination against interstate commerce, either in the admeasurement of the tax or in the means adopted for enforcing it*, it constitutes one of the ordinary and general burdens of government, from which persons and corporations otherwise subject to the jurisdiction of the states are not exempted by the Federal Constitution because they happen to be engaged in commerce among the states." (Italics supplied).

In the case at bar, it is admitted that for the tax year under consideration, plaintiff, after paying rent for hired property used in the conduct of transportation in interstate commerce, and interest, had nothing left from its entire receipts or gross income for that year. Yet the State calls upon plaintiff to pay an income tax of over \$18,000.00.

The admeasurement of the tax consists of applying the rate of taxation to the basis of taxation. When all corporations other than those engaged in interstate commerce as common carriers are allowed to deduct rent of facilities used in the business—and interest paid, from their gross income, and this privilege is not allowed common carriers by railroad engaged in interstate commerce, the rate of taxation being the same, there is necessarily a discrimination in the admeasurement of the tax, to the disadvantage of the interstate carriers.

In *United States Glue Company, supra*, Mr. Justice Brandies, referring to the cases of *Crew Levick Co. v. Pennsylvania*, 245 U. S., 292, and *Peck Co. v. Lowe*, 247 U. S., 165, says:

"The correct line of distinction is so well illustrated in two cases decided at the present term that we hardly need

go further. In *Crew Levick Co. v. Pennsylvania*, 245 U. S., 292, we held that a state tax upon the business of selling goods in foreign commerce, measured by a certain percentage of the gross transactions in such commerce, was by its necessary effect a tax upon the commerce, and at the same time a duty upon exports, contrary to paragraphs 8 and 10 of Article 1 of the Constitution, since it operated to lay a direct burden upon every transaction by withholding for the use of the State a part of every dollar received. On the other hand, in *Peck & Co. v. Lowe*, 247 U. S., 165, we held that the income tax of October 3, 1913, chap. 16, paragraph II, Stat. at L. 166, 172, when carried into effect by imposing an assessment upon the entire net income of a corporation, approximately three-fourths of which was derived from the export of goods to foreign countries, did not amount to laying a tax or duty on articles exported within the meaning of Art. 1, sec. 9, cl. 5 of the Constitution. The distinction between a direct and an indirect burden by way of tax or duty was developed, and it was shown that an income tax laid generally on net incomes, *not on income from exportation because of its source, or in the way of discrimination, but just as it was laid on other income, and affecting only the net receipts from exportation after all expenses were paid and losses adjusted and the recipient of the income was free to use it as he chose, was only an indirect burden.*" (Italics supplied).

The case at bar comes within the same class as the *Crew Levick Co. case*; it is true that the tax under consideration is not one laid upon the gross receipts from transportation; neither is it laid upon the "net income" for "income" does not enter into the tax, only revenue from transportation.

On the other hand, it is true that the tax is not upon the net income after all losses and expenses are paid and the recipient is free to use the balance as he chooses.

Until the recipient pays his rent and interest he is not free to use his income as he chooses.

The tax, therefore, is one upon the receipt from interstate commerce, as such, and therefore void, unless the court is of opinion that the State has the power to tax gross receipts from interstate transportation as such except that part thereof necessary to be used in paying the cost of conducting such transportation.

True the present statute allows a deduction of car hire debit balance, if any exists, but if the power exists to exclude the rent of a track for the car to run over, the same legal principles gives the right to exclude the rent of a car to haul the commodities.

If the power exists to exclude rent of facilities the same legal principles sustain the power to exclude taxes.

If a corporation, in order to do interstate commerce has to hire a track to operate on, a car to operate with, pay taxes thereon as property—and pay interest on money borrowed to pay employees, these constitute a part of the expense of conducting the business, but they do not under the rules of the Interstate Commerce Commission constitute a part of the cost of conducting transportation.

They are all under the rules of the Interstate Commerce Commission excluded from the costs of conducting transportation, they come under the head of income accounts, and constitute a part of the expense of doing business, if one can be excluded in order to ascertain "net income" all can be excluded.

The Interstate Commerce Act, requires transportation to be conducted efficiently and economically, in order that the Commission may consider that duty, a system of accounting is required to show in detail the cost of the various services necessary to perform the act of transportation and its incidents. That part of the accounts does not determine either gross or net income of the carrier.

It is well settled that gross receipts from interstate commerce may not be taxed by a percentage thereof. *United States Glue Company v. Oak Creek Co.*, *supra*, and *Crew Devick Co. v. Pennsylvania*, *supra*, it is settled that the "net income" of a

carrier, although derived from interstate commerce, may be taxed. Is there a line midway between the two where the power of taxation, of receipts, ends? If so, where? We submit that the power ends with the taxation of the "net income."

PART IV.

THE STATUTE CONTRAVENES THE EQUAL PROTECTION CLAUSE OF THE XIV AMENDMENT.

In *Royster Guano Company v. Virginia*, 253 U. S., 412, 415, 420, the Court, through Mr. Justice Pitney, said:

"It is unnecessary to say that the 'equal protection of the laws' required by the Fourteenth Amendment does not prevent the State from resorting to classification for the purpose of legislation. Numerous and familiar decisions of this Court establish that they have a wide range of discretion in that regard. But the classification must be reasonable, not arbitrary and *must rest upon some ground of difference, having a fair and substantial relation to the object of the legislation, so that all persons similarly circumstanced shall be treated alike*. The latitude of discretion is notably wide for the purpose of taxation and the granting of partial or total exemptions upon the grounds of policy. *Bell's Gap R. R. Co. v. Pennsylvania*, 134 U. S., 232, 237; *Michigan R. R. Co. v. Powers*, 201 U. S., 245, 293; *Keeney v. New York*, 222 U. S., 525, 536; *Citizen Telephone Co. v. Fuller*, 229 U. S., 322, 329; *Northwestern Mutual Life Ins. Co. v. Wisconsin*, 247 U. S., 132, 139. Nevertheless, a discriminatory tax law cannot be sustained against the complaints of a party aggrieved, if the classification appears to be altogether illusory." (Italics supplied).

The thing in respect to which the classification in the case at bar is imposed is "net income" for the purpose of taxation.

The classification is made upon the basis of how corporations are required to keep their records.

In the case at bar, it appears that one class of corporations are required by law to keep their records according to certain rules prescribed by the Interstate Commerce Commission, all other corporations are permitted to keep such records as they deem best.

It appears that only those corporations engaged in interstate or foreign commerce, as common carriers by railroad, by pipe line or of intelligence are required to keep them according to the method used by the statutes, as a means of selecting or designating the class to which it is applicable.

Therefore, the real, true classification is:

(a) Those common carriers engaged in interstate commerce by railroad, pipe line or the transmission of intelligence; and,

(b) All other corporations, including common carriers engaged in intrastate commerce alone, by railroad, pipe line and the transmission of intelligence.

The real classification then is based on whether the corporation is or is not engaged as a common carrier in interstate commerce.

The result of the classification is to allow one class of corporations to deduct from their gross income all rents paid for the continued use in the business, and all interest paid and losses incurred, in order to ascertain their "net income"; this privilege is denied to the other class, the class engaged in interstate transportation.

If the basis of classification, to make it legal, must be, as said in the *Royster case*, *supra*, "*That all persons similarly circumstanced shall be treated alike*," then the statute must fall.

Two corporations, one a common carrier engaged in interstate commerce, the other an industrial corporation, both rent a plant, with which to conduct their business, both pay interest, both borrow money to supply additional facilities, or to pay employees, both pay interest on funded and unfunded debt; the industrial corporation is allowed to deduct from its gross income the rent and interest paid before taxation as net, the other is refused this privilege.

Both are similarly circumstanced as to the payment of rent and interest, it is true that their gross income comes from different occupations, but that does not affect the question of what constitutes "net income," and if it should be held to be affected by the source from which the gross comes, i.e., Interstate Commerce, then it would be a tax upon that business and as such in contravention of the United States Constitution.

The affidavit of A. J. Maxwell (Pr. R., page 30, 31), gives the reason that prompted the Legislature to adopt the classification that it did.

(1) For excluding from deductions allowed to *Interstate Common Carriers* by railroad, rental of leased roads and track-age rights.

That these leases are usually for a long term and with numerous collateral obligations.

(2) That as to interest on bonded debts, that railroads are financed by bond issues.

(3) That if these items of expense are allowed as deductions to the plaintiffs "THE RESULT WOULD BE THAT THEY WOULD HAVE NO INCOMES SUBJECT TO TAX UNTIL THEY HAD EARNED ENOUGH TO PROVIDE NOT ONLY FOR ALL BUSINESS AND OPERATING EXPENSES, BUT ALSO FOR ALL CAPITAL EXPENSES AND HAD PAID ALL INTEREST ON THEIR BONDS. IN OTHER WORDS, IT WOULD AMOUNT TO NOTHING MORE THAN A TAX UPON SAVINGS OF RAILROADS."

United States Glue Company v. Oak Creek, supra, and *Crew Levick v. Pennsylvania, supra*, *Peck Co. v. Lowe, supra*, all say that the savings of a taxpayer, that which is left of his income, that he may use as he chooses, is what may be taxed as "net income," even though derived from interstate commerce.

The affidavit filed by the State, shows conclusively that the Legislature drew a bill which taxed and was intended to tax more than this "net income."

This money paid by plaintiff for leased roads is subject

to income taxes in the hands of the lessor, and a tax is paid thereon to the State of North Carolina, as both lessors are North Carolina corporations, not engaged in interstate commerce. The interest paid on plaintiff's bonds, if held in North Carolina, is subject to income taxation in the hands of the holder.

True, Mr. Maxwell, in his affidavit, says all railroads are in one class, but the evidence does not bear him out. The words of the statutes are different, and the statute controls.

State v. Green, 126 N. C., 1032.

Attorney General v. Bank, 57 N. C., 287.

42 Broadway v. Anderson, 209 Fed., 991, 993.

PART V.

THE STATUTE CONTRAVENES THE UNIFORMITY CLAUSE OF THE STATE CONSTITUTION.

The Constitution of the State, Article V, Sec. 3, provides:

"Taxation shall be by uniform rule and ad valorem: Exemptions. Laws shall be passed taxing, by a uniform rule, all moneys, credits, investments in bonds, stocks, joint-stock companies, or otherwise; and, also, all real and personal property, according to its true value in money: *Provided*, notes, mortgages, and all other evidence of indebtedness given in good faith for the purchase price of a home, when such purchase price does not exceed three thousand dollars, and said notes, mortgages, and other evidence of indebtedness shall be made to run for not less than five nor more than twenty years, shall be exempt from taxation of every kind: *Provided*, that the interest carried by such notes and mortgages shall not exceed five and one-half per cent. The General Assembly may also tax trades, professions, franchises, and income: *Provided*, the rate of tax on incomes shall not in any case exceed six per cent (6%), and there shall be allowed the following exemptions, to be deducted from the amount of annual incomes, to-wit: for a married man with a wife living with him, or to a widow

or widower having minor child or children, natural or adopted, not less than \$2,000; to all other persons not less than \$1,000, and there may be allowed other deductions (not including living expenses) so that only net incomes are taxed."

Under the construction put upon this section of the Constitution by the highest Court of the State, all taxes upon trades, professions and incomes must be uniform as to all persons belonging to the same class.

Smith v. Wilkins, 164 N. C., 135, 143.

Gatlin v. Tarboro, 78 N. C., 119, 132.

Lacy v. Packing Co., 134 N. C., 567, 571.

State v. Williams, 158 N. C., 610, 613.

Where the Court says:

"Constitutional and legislative authority conferred upon a municipality to tax does not enable it to create a privilege for the purpose of taxing it, or to discriminate between persons exercising the same privilege by imposing a tax upon one of a class at a higher rate, in a different mode or upon other principles than one applied to the exercise of the same privilege of the same class."

The affidavits of F. C. Harding, A. R. Turnbull, Nathan O'Berry and O. S. Thompson show that there are a number of railroads in the State, which act as common carriers. True, their principal business is hauling logs for their owners; true, they only haul a limited class of commodities; true, they do not run regular schedules; true, that their common carrier business is light, and they may operate at a loss. (So did the plaintiff, after paying rent and interest during the tax year under consideration.) True, the Corporation Commission says it does not treat them in the same way or same class as the larger roads; true, the Commissioner of Revenue says he construes Section 202 as applying to them, but they do not agree to this construction of the law, and do not come within the terms of the statute.

If these limited common carriers by steam railroad are not treated by the Corporation Commission as other common carriers by steam railroad are treated, it shows that the Commission does not follow the Supreme Court of the State.

Stewart v. Lumber Co., 146 N. C., 47, 49.

They are all in the same class as to what constitutes "net income."

The statute denies equal treatment to all of those in the same class.

A corporation doing a large business at a loss is in the same class as a corporation doing a small business of the same kind at a loss, so far as "net income" is concerned. If the corporation doing a small business does it at a profit that puts it in a better class than if it did a large business at a loss.

Wherefore, it is respectfully submitted that the statute and the tax assessed and sought to be collected are illegal and void, as being in contravention of the Constitution of the United States, Article 1, Sec. 8 (Commerce Clause), for that:

(1) It is a tax, not upon plaintiff's net income, but upon plaintiff's revenues derived from interstate and foreign commerce, and as such bears directly upon and burdens interstate commerce.

(2) That the tax is laid, not upon plaintiff's "net income," but upon plaintiff by reason of the fact that it is engaged in interstate commerce, and in a discriminatory manner, as to mode and admeasurement.

(3) It is in violation of the XIV Amendment because it selects plaintiff and others similarly situated, based upon the sole fact that plaintiff is engaged in interstate commerce and is therefore void.

(4) That it contravenes the uniformity clause of the State Constitution.

W. B. RODMAN,
C. M. BAIN,
For Plaintiff.

APPENDIX "A"

In the District Court of the United States for the Eastern District of North Carolina.

(Title of Cause.)

ASSIGNMENT OF ERRORS

The plaintiff prays an appeal from the final decree of this Court, to the Supreme Court of the United States, and assigns for error:

(1) That Schedule "D" of the said Act of the General Assembly of the State of North Carolina, Chapter 34 Public Laws of 1921, being an act entitled "An Act to Raise Revenue," ratified the 8th day of March, 1921, and the amendments and supplements thereto, and especially the said act as amended by Chapter 102 of the Public Laws of the Extra Session, 1921, ratified the 19th day of December, 1921, and entitled "An Act to Amend Chapter 34 of the Public Laws of 1921, being an Act to Raise Revenue, relative to privilege tax and the Income Tax on Railroads," is in contravention of the Constitution of the United States, especially of the interstate commerce laws, section 8, article 1; of section 2, article 4; of section 1, article 14.

(2) That the said Act is in contravention of the Constitution of the State of North Carolina, especially of section 3, article 5.

(3) That said Act does not provide a method for the taxation of income of the complainant as required by the Constitution of the State, or by uniform rule as compared with the income of other citizens, residents, persons or corporations doing business in the State of North Carolina, and subject to an income tax, but is really an attempt to enforce against Norfolk Southern Railroad Company and other interstate carriers in the State of North Carolina and of the United States, engaged in interstate commerce, the payment of a tax on account of and for the reason that this plaintiff, and other companies

similarly situated, are engaged in the business of conducting and carrying on interstate commerce by attempting through an unjust, unreasonable and illegal classification to require plaintiff and other railroad companies doing business in the State of North Carolina and engaged in interstate commerce, to pay an income tax upon more than their net income, while all other tax payers are taxed upon their net income.

(4) That the assessment for income tax made by the defendant, A. D. Watts, as Commissioner of Revenue, against the plaintiff was not made upon the net income of this plaintiff, but was made upon what was termed its "net operating income," while all other individuals and corporations doing business in the State of North Carolina and subject to income tax had their income tax assessed upon the basis of their net income, except corporations engaged in the business of operating steam or electric railroads, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the Standard Classification of Accounting of the Interstate Commerce Commission.

That the said assessment of the income tax made by the defendant, A. D. Watts, as Commissioner of Revenue of North Carolina, was illegal and void, as being made upon a classification of plaintiff and other public service corporations engaged in interstate commerce and required to report to the Interstate Commerce Commission, and to keep their records in accordance with the orders of that Commission, and thereby imposed, or undertook to impose a tax upon the plaintiff by reason of the fact that it was engaged in interstate commerce, which tax is greater than would be imposed upon plaintiff if it were not engaged in such interstate commerce, and undertook to classify, for the purpose of an income tax and of ascertaining what constituted net income, taxpayers into two classes, to-wit: Those engaged in interstate commerce in the operation of public service, as common carriers, and all other taxpayers in the other class. That such classification was and is in violation and contravention of the Constitution of the United States,

especially of the interstate commerce clause of section 8, article 1; of section 2, article 4, and of section 1, article 14, and is in violation and in contravention of the Constitution of the State of North Carolina, especially section 3, article 5 thereof.

(5) That the court erred in holding that the United States District Court was without jurisdiction to hear and determine the questions raised by the bill and answer filed in this cause.

(6) That the court erred in holding that the plaintiff was not entitled to have the defendants, or either of them, enjoined or restrained from the performance of the duties imposed upon them by the statutes of North Carolina, relating to the administration, assessing, levying and enforcement of collection of the income tax against plaintiff, and in dismissing the bill.

(7) That the court erred in refusing to enjoin the defendants from undertaking to enforce the collection of the assessment of income tax against the plaintiff, as made by A. D. Watts, Commissioner of Revenue.

W. B. RODMAN,
Attorney for Plaintiff.

APPENDIX "B"

Chapter 34, Public Laws, 1921, as amended by Chapter 102, Public Laws, Extra Session, 1921, and by Chapter 35, Public Laws, 1921.

SCHEDULE D.

INCOME TAX

AN ACT PROVIDING FOR THE LEVYING, COLLECTING, AND PAYING OF AN INCOME TAX ON INDIVIDUALS AND CORPORATIONS.

ARTICLE I

SHORT TITLE AND DEFINITIONS

Sec. 100. *Short Title.* This Act shall be known and may be cited as The Income Tax Act of 1921.

Sec. 101. *Purpose.* The general purpose of this act is to impose a tax, for the use of the State Government, upon the net income for the calendar year 1921, in excess of exemptions herein set out, collectible in the year 1922, and annually thereafter.

- (a) Of every citizen of the State.
- (b) Of every domestic corporation.
- (c) Of every foreign corporation and of every nonresident individual having a business or agency in this State, in proportion to the net income of such business or agency.

Except as otherwise provided in this act the purpose is to conform to the definitions of income in the revenue laws of the United States Government and regulations made under its authority, in so far as they apply.

The tax imposed upon the net income of corporations in this schedule is in addition to the tax imposed under Schedule C of this act.

Sec. 102. *Definitions.* For the purpose of this act and unless otherwise required by the context:

1. The words "Tax Commission" means the State Tax Commission.
2. The word "taxpayer" includes any individual, corporation or fiduciary subject to the tax imposed by this act.
3. The word "individual" means a natural person.
4. The word "fiduciary" means a guardian, trustee, executor, administrator, receiver, conservator, or any person, whether individual or corporation, acting in any fiduciary capacity for any person, estate or trust.
5. The word "person" includes individuals, fiduciaries, partnerships and corporations.
6. The word "corporation" includes joint-stock companies or associations and insurance companies.
7. The words "domestic corporation" mean any corporation organized under the laws of this State.
8. The words "foreign corporation" mean any corporation other than a domestic corporation.

9. The words "tax year" mean the calendar year in which the tax is payable.

10. The words "income year" mean the calendar year or the fiscal year, upon the basis of which the net income is computed under this act; if no fiscal year has been established they mean the calendar year.

11. The words "fiscal year" mean an income year, ending on the last day of any month other than December.

12. The word "paid" for the purpose of the deductions under this act means "paid or accrued" or "paid or incurred," and the words "paid or accrued," "paid or incurred," and "incurred" shall be construed according to the method of accounting upon the basis of which the net income is computed under this act. The word "received" for the purpose of the computation of the net income under this act means "received or accrued," and the words "received or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under this act.

13. The word "resident" applies only to individuals, and includes for the purpose of determining liability to the tax imposed by this act, with reference to the income of any income year, any individual who shall be a resident of the State on the first day of the tax year. In the absence of other satisfactory indicia the residence of a person who has two or more places in which he occasionally dwells may be determined with reference to the place at which the individual lived the longest period of time during the income year.

14. The words "foreign country" mean any jurisdiction other than one embraced within the United States. The words "United States," when used in a geographical sense, include the States, the Territories of Alaska and Hawaii, the District of Columbia, and the possessions of the United States.

ARTICLE II

IMPOSITION OF TAX

Sec. 200. *Individuals.* A tax is hereby imposed upon every

resident of the State, which tax shall be levied, collected and paid annually, with respect to the net income of the taxpayer as herein defined, and upon income earned within this State of every nonresident having a business or agency in the State, computed at the following rates, after deducting the exemptions provided in this act:

On the excess over the amount legally exempted up to twenty-five hundred dollars, one per cent:

On the excess above twenty-five hundred dollars and up to five thousand dollars, one and one-half per cent.

On the excess above five thousand dollars and up to seven thousand, five hundred dollars, two per cent.

On the excess above seven thousand, five hundred dollars and up to ten thousand dollars, two and one-half per cent.

On the excess over ten thousand dollars, three per cent.

Sec. 201. *Corporations.* Every corporation organized under the laws of this State shall pay annually an income tax, equivalent to three per cent of the entire net income of such corporation, as herein defined, received by such corporation during the income year; and every foreign corporation doing business in this State shall pay annually an income tax equivalent to three per cent of a proportion of its entire net income, to be determined according to the following rules:

In case of a company other than companies mentioned in the next succeeding section, deriving profits principally from the ownership, sale, or rental of real estate or from the manufacture, sale, or use of tangible personal property, such proportion of its entire net income as the fair cash value of its real estate and tangible personal property in this State on the date of the close of the fiscal year of such company in the income year is to the fair cash value of its entire real estate and tangible personal property then owned by it, with no deduction on account of incumbrances thereon.

In case of a corporation deriving profits principally from the holding or sale of tangible property, such proportion as its gross receipts in this State for the year ended on the date of the close

of its fiscal year next preceding is to its gross receipts for such year within and without the State.

Sec. 202. *Railroads and public service corporations.* The basis of ascertaining the net income of every corporation engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, shall be the "net operating income" of such corporation as shown by their records kept in accordance with that standard classification of accounts, when their business is wholly within this State, and when their business is in part within and in part without the State their net income within this State shall be ascertained by taking their gross "operating revenues" within this State, including in their gross "operating revenues" within this State the equal mileage proportion within this State of their interstate business and deducting from their gross "operating revenues" the proportionate average of "operating expenses," or "operating ratio," for their whole business, as shown by the Interstate Commerce Commission standard classification of accounts. From the net operating income thus ascertained shall be deducted "uncollectible revenue," and taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes, and the balance shall be deemed to be their net income taxable under this act.

Sec. 203. Such tax shall first be levied, collected, and paid in the year 1922, and with respect to the net income received during the calendar year 1921 and annually thereafter.

Sec. 204. *Conditional and other exemptions.* The following organizations shall be exempt from taxation under this act:

(1) Fraternal beneficiary societies, orders or associations, (a) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and (b) providing for the payment of life, sick, accident

or other benefits to the members of such society, order or association or their dependents.

(2) Building and loan associations and coöperative banks without capital stock, organized and operated for mutual purposes and without profits.

(3) Cemetery corporations and corporations organized for religious, charitable, scientific, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual.

(4) Business leagues, chambers of commerce, or boards of trade, not organized for profit and no part of the net earnings of which inures to the benefit of any private stockholder or individual.

(5) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare.

(6) Clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, no part of the net earnings of which inures to the benefit of any private stockholder or member.

(7) Farmers' or other mutual hail, cyclone, or fire insurance companies, mutual ditch or irrigation companies, mutual or coöperative telephone companies or like organizations of a purely local character, the income of which consists solely of assessments, dues, and fees collected from members for the sole purpose of meeting expenses.

(8) Farmers, fruit growers', or like organizations, organized and operated as sales agents for the purpose of marketing the products of members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity of produce furnished by them.

Sec. 205. *Fiduciaries.* The tax imposed by this act shall be imposed upon resident fiduciaries, and upon nonresident fiduciaries, having in charge funds or property for the benefit of a resident in this State, which tax shall be levied, collected and paid annually with respect to:

(a) That part of the net income of estates or trusts which has not been distributed or become distributable to beneficiaries during the income year.

(b) The net income received during the income year by deceased individuals who, at the time of death were residents and who have died during the tax year or the income year without having made a return.

(c) The entire net income of resident insolvent or incompetent individuals, whether or not any portion thereof is held for the future use of the beneficiaries, where the fiduciary has complete charge of such net income.

2. The tax imposed upon a fiduciary by this act shall be a charge against the estate or trust.

ARTICLE III

Sec. 300. *Net income defined.* The words "net income" mean the gross income of a taxpayer less the deductions allowed by this act.

Sec. 301. *Gross income defined.* 1. The words "gross income" include gains, profits and income derived from salaries, wages or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, business, commerce or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transactions of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income of the income year in which received by the taxpayer, unless, under the methods of accounting permitted under this act, any such amounts are to be properly accounted for as of a different period.

2. The words "gross income" do not include the following items, which shall be exempt from taxation under this act.

(a) The proceeds of life insurance policies and contracts

paid upon the death of the insured to individual beneficiaries or to the estate of the insured.

(b) The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract.

(c) The value of property acquired by gift, bequest, devise or descent (but the income from such property shall be included in gross income).

(d) Interest upon the obligations of the United States or its possessions, or of the State of North Carolina.

(e) Salaries, wages, or other compensation received from the United States by officials or employees thereof, including persons in the military or naval forces of the United States.

(f) Any amounts received through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received, whether by suit or agreement, on account of such injuries or sickness.

Sec. 302. *Basis of return of net income.* 1. Taxpayers who customarily estimate their income on a basis other than that of actual cash receipts and disbursements may, with the approval of the Tax Commission, return their net income under this act upon a similar basis. Taxpayers who customarily estimate their income on the basis of an established fiscal year instead of on that of the calendar year, may, with the approval of the tax Commission, and subject to such rules and regulations as it may establish, return their net income under this act on the basis of such fiscal year, in lieu of that of the calendar year.

2. A taxpayer may, with the approval of the Tax Commission and under such regulations as it may prescribe, change the income year from fiscal year to calendar year or otherwise, in which case his net income shall be computed upon the basis of such new income year.

3. An individual carrying on business in partnership shall be

liable for income tax only in his individual capacity, and shall include in his gross income the distributive share of the net income of the partnership received by him or distributed to him during the income year.

4. Every individual taxable under this act who is a beneficiary of an estate or trust, shall include in his gross income the distributive share of the net income of the estate or trust, received by him or distributable to him during the income year. Unless otherwise provided in the law, the will, the deed, or other instrument creating the estate, trust or fiduciary relation, the net income shall be deemed to be distributed or distributable to the beneficiaries (including the fiduciary as a beneficiary, in the case of income accumulated for future distribution) ratably, in proportion to their respective interests.

Sec. 303. *Determination of gain or loss.* For the purpose of ascertaining the gain or loss from the sale or other disposition of property, real, personal or mixed, the basis shall be, in the case of property acquired before January 1, 1921, the fair market price or value of such property as of that date, if such price or value exceeds the original cost, and in all other cases, the cost thereof: *Provided*, that in the case of property which was included in the last preceding annual inventory used in determining net income in a return under this act, such inventory value shall be taken in lieu of cost or market value. The final distribution to the taxpayer of the assets of a corporation shall be created as a sale of the stock or securities of the corporation owned by him and the gain or loss shall be computed accordingly. If at any time gains and profits realized by sale of property by other than traders in such property at an increase over the purchase price, or an increase over the fair value of the property on January 1, 1921, shall be held by the Supreme Court of the United States not to be taxable income by the United States Government, such decision shall govern the liability of such gains and profits for taxation as income under this act.

Sec. 304. *Exchanges of property.* 1. When property is ex-

changed for other property, the property received in exchange shall, for the purpose of determining gain or loss, be treated as the equivalent of cash to the amount of its fair market value: *Provided*, a market exists in which all the property so received can be disposed of at the time of exchange, for a reasonably certain and definite price in cash; otherwise such exchange shall be considered as a conversion of assets from one form to another, from which no gain or loss shall be deemed to arise.

2. In the case of the organization of a corporation, the stock or securities received shall be considered to take the place of property transferred therefor and no gain or loss shall be deemed to arise therefrom.

3. When, in connection with the reorganization, merger, or consolidation of a corporation, a taxpayer receives, in place of stock or securities owned by him, new stock or securities, the basis of computing the gain or loss if any shall be, in case the stock or securities owned were acquired before January 1, 1921, the fair market price or value thereof as of that date, if such price or value exceeds the original cost, and in all other cases the cost thereof.

Sec. 305. *Inventory.* Whenever in the opinion of the Tax Commission the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer, upon such basis as the Tax Commission may prescribe, conforming as nearly as may be the best accounting practice in the trade or business and most clearly reflecting the income, and conforming so far as may be, to the forms and methods prescribed by the United States Commissioner of Internal Revenue, under the act of Congress then providing for the taxation of income.

Sec. 306. *Deductions.* In computing net income there shall be allowed as deductions:

1. All the ordinary and necessary expenses paid during the income year in carrying on any trade or business, including:

(a) As to individuals, wages of employees for services actually rendered in producing such income.

(b) As to partnerships, wages of employees and a reasonable allowance for copartners or members of a firm, for services actually rendered in producing such income, the amount of such salary allowance to be included in the personal return of the copartner receiving same.

(c) As to corporations, wages of employees and salaries of officers, if reasonable in amount, for services actually rendered in producing such income.

2. Rentals or other payments required to be made as a condition of the continued use or possession, for the purposes of the trade of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

3. All interest paid during the income year on indebtedness except interest on obligations contracted for the purchase of nontaxable securities. Dividends on preferred stock shall not be deducted as interest.

4. Taxes for the income year, except taxes on income and war profits, and excess profits taxes, inheritance taxes, and taxes assessed for local benefit of a kind tending to increase the value of the property assessed.

5. Dividends from stock in any corporation the income of which shall have been assessed and the tax on such income paid by the corporation under the provisions of this act: *Provided*, that when only part of the income of any corporation shall have been assessed under this act only a corresponding part of the dividends received therefrom shall be deducted.

6. Losses sustained during the income year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit.

7. Debts ascertained to be worthless and charged off within the income year, if the amount has previously been included in gross income in a return under this act.

8. A reasonable allowance for the depreciation and obsolescence of property used in the trade or business; and, in the case of mines, oil, and gas wells, other natural deposits, and timber, a reasonable allowance for depletion: *Provided*, that in

computing the deductions allowed under this paragraph, the basis shall be the cost (including in the case of mines, oil, and gas wells, and other natural deposits, the cost of development, not otherwise deducted), and in the case of property acquired prior to January 1, 1921, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date. The reasonable allowances under this paragraph shall be made under rules and regulations to be prescribed by the Tax Commission. In the case of leases the deductions allowed may be equitably apportioned between the lessor and lessee.

9. In the case of taxpayers who keep regular books of account, upon an accrual basis and in accordance with standard accounting practice, reserves for bad debts and for contingent liabilities, under such rules and restrictions as the Tax Commission may impose. If the Tax Commission shall at any time deem the reserve excessive in amount it may restore such excess to income, either in a subsequent year or as a part of the income of the income year and assess it accordingly.

10. Contributions or gifts made within the taxable year to corporations or associations operated exclusively for religious, charitable, scientific or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, to an amount not in excess of fifteen per centum of the taxpayer's net income as computed without the benefit of this subdivision.

11. Resident individuals having an established business in another State, or investment in property in another State, may deduct the net income from such business or investment, if such business or investment is in a State that levies a tax upon such net income. The deduction authorized in this subsection shall in no case extend to any part of income of resident individuals from personal services, or mortgages, stocks, bonds, securities and deposits.

12. In the case of a nonresident individual, the deductions

allowed in this section shall be allowed only if, and to the extent that, they are connected with income arising from sources within the State; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the State shall be determined under rules and regulations prescribed by the State Tax Commission.

Sec. 307. *Items not deductible.* In computing net income no deduction shall in any case be allowed in respect of:

(a) Personal, living, or family expenses.

(b) Any amount paid out for new buildings or for permanent improvements or betterments, made to increase the value of any property or estate.

(c) Any amount expended in restoring property for which an allowance is or has been made.

(d) Premiums paid on any life insurance policy.

Sec. 308. *Exemptions.* 1. There shall be deducted from the net income the following exemptions:

(a) In the case of a single individual, a personal exemption of \$1,000.

(b) In the case of a married man with a wife living with him, \$2,000.

(c) In the case of a widow or widower having minor child or children, natural or adopted, \$2,000.

(d) \$200 for each individual (other than husband and wife) dependent upon and receiving his chief support from the taxpayer, if such dependent individual is under eighteen years of age or is incapable of self-support, because mentally or physically defective.

(e) In the case of a fiduciary, if taxable under clause (a) of paragraph 1 of sec. 205, a personal exemption of \$1,000; if taxable under clause (b) of said paragraph, the same exemption as would be allowed the deceased, if living; if taxable under clause (c) of said paragraph the same exemptions to which the beneficiary would be entitled.

2. The exemptions allowed by this section shall not be allowed with respect to a resident of this State having income

from a business or agency in another State, or with respect to a nonresident having a business or agency in this State, unless the entire income of such resident or nonresident individual is shown in the return of such resident or nonresident, and if the entire income is so shown the exemption shall be probated in the proportion of the income in this State to the total income.

3. The status on the last day of the income year shall determine the right to the exemptions provided in this section: *Provided*, that a taxpayer shall be entitled to such exemptions for husband or wife or dependent who has died during the income year.

ARTICLE IV

RETURNS

Sec. 400. *Returns.* 1. Every resident or nonresident having a net income during the income year taxable in this State of \$1,000 and over, if single, or if married and not living with husband or wife; or having a net income for the income year of \$2,000 or over, if married and living with husband or wife; and every corporation having a net income in excess of \$1,000, shall make a return under oath, stating specifically the items of gross income and the deductions and exemptions allowed by this act, and such other facts as the Tax Commission may require for the purpose of making any computation required by this act. When the Tax Commission has reason to believe any person or corporation is liable for tax under this act, it may require any such person or corporation to make a return.

2. If a husband and wife living together have an aggregate net income of \$2,000 or over, each shall make such a return, unless the income of each is included in a single joint return.

3. If the taxpayer is unable to make his own return, the return shall be made by a duly authorized agent or by a guardian or other person charged with the care of the person or property of such taxpayer.

4. The return by a corporation shall be sworn to by the

president, vice president, or other principal officer, and by the treasurer or assistant treasurer.

5. The return of an individual who, while living, received income in excess of the exemption during the income year and who has died before making the return, shall be made in his name and behalf by the administrator or executor of the estate and the tax shall be levied upon and collected from his estate. Before a corporation shall be dissolved and its assets distributed it shall make return for and settlement of tax for any income earned in the tax year up to its period of dissolution.

6. Where the Tax Commission has reason to believe that any taxpayer so conducts the trade or business as either directly or indirectly to distort his true net income and the net income properly attributable to the State, whether by the arbitrary shifting of income, through price fixing, charges for service or otherwise, whereby the net income is arbitrarily assigned to one or another unit in a group of taxpayers carrying on business under a substantially common control, it may require such facts as it deems necessary for the proper computation of the entire net income and the net income properly attributable to the State and in determining the same the Tax Commission shall have regard to the fair profit which would normally arise from the conduct of the trade or business.

Sec. 401. *Fiduciary returns.* 1. Every fiduciary subject to taxation under the provisions of this act as provided in section 205 hereof, shall make a return under oath, for the individual, estate or trust for whom or for which he acts, if the net income thereof amounts to \$1,000 or over.

2. The return made by a fiduciary shall state specifically the items of gross income, and the deductions and exemptions allowed by this act and such other facts as the Tax Commission may prescribe. Under such regulations as the Tax Commission may prescribe a return may be made by one or two or more joint fiduciaries.

3. Fiduciaries required to make returns under this act shall

be subject to all the provisions of this act which apply to individuals.

Sec. 402. *Information at source.* 1. Every individual, partnership, corporation, joint stock company or association or insurance company, being a resident or having a place of business in this State, in whatever capacity acting, including lessee or mortgagors of real or personal property, fiduciaries, employers and all officers and employees of the State or of any political subdivision of the State, having the control, receipt, custody, disposal or payment of interest (other than interest coupons payable to bearer), rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments or other fixed or determinable annual or periodical gains, profits and income, amounting to \$1,000 or over paid, or payable during any year to any taxpayer, shall make complete return thereof to the Tax Commission, under such regulations and in such form and manner and to such extent as may be prescribed by it.

2. Every partnership, having a place of business in the State, shall make a return, stating specifically the items of its gross income and the deductions allowed by this act, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed, and the amount of the distributive share of each individual. The return shall be sworn to by one of the partners.

3. Every fiduciary shall make, under oath, a return for the individual, estate or trust for whom or for which he acts, if the net income thereof, distributed or distributable to beneficiaries during the year is one thousand dollars or over, in which case the fiduciary shall set forth in such return the items of the gross income, the deductions allowed by this act, and the net income, the names and addresses of the beneficiaries, the amounts distributed or distributable to each and the amount, if any, lawfully retained by him for future distribution. Such return may be made by one of two or more joint fiduciaries.

Sec. 403. *Time and place of filing returns.* Returns shall be in such forms as the Tax Commission may from time to

time prescribe and shall be filed with the Tax Commission, at its main office or at any branch office which it may establish, on or before the fifteenth day of March in each year, and for all taxpayers using a fiscal year, within sixty days after expiration of the fiscal year. In case of sickness, absence, or other disability, or whenever in its judgment good cause exists, the Tax Commission may allow further time for filing returns. There shall be annexed to the return the affidavit or affirmation of the taxpayer making the return, to the effect that the statements contained therein are true. The Tax Commission shall cause to be prepared blank forms for the said returns and shall cause them to be distributed throughout the State and to be furnished upon application, but failure to receive or secure the form shall not relieve any taxpayer from the obligation of making any return herein required.

Sec. 404. *Blank forms to be kept on file with Register of Deeds.* For convenience of all parties liable for making a return of income, and who may not receive blank forms by mail for this purpose, the State Tax Commission shall keep on deposit with the Register of Deeds in each county a supply of blank forms for distribution.

Sec. 405. *Failure to file returns; supplementary returns.* If the Tax Commission shall be of the opinion that any taxpayer has failed to file a return, or to include in a return filed, intentionally or through error, items of taxable income, it may require from such taxpayer a return, or a supplementary return, under oath, in such form as it shall prescribe, of all the items of income which the taxpayer received during the year for which the return is made, whether or not taxable under the provisions of this act. If from a supplementary return, or otherwise, the Tax Commission finds that any items of income, taxable under this act, have been omitted from the original return, or any items returned as taxable that are not taxable, or any item of taxable income overstated, it may require the items so omitted to be disclosed to it, under oath of the taxpayer, and to be added to or deducted from the original return. Such

supplementary return and the correction of the original return shall not relieve the taxpayer from any of the penalties to which he may be liable under any provision of this act. The Tax Commission may proceed under the provisions of section 502 of this act, whether or not it requires a return or a supplementary return under this section.

ARTICLE V

COLLECTION AND ENFORCEMENT OF TAX

Sec. 500. *Time and place of payment of tax.* 1. The full amount of the tax payable, as the same shall appear from the face of the return, shall be paid to the Tax Commission at the office where the return is filed at the time fixed by law for filing the return. If the time for filing the return shall be extended, interest at the rate of six per cent per annum, from the time when the return was originally required to be filed, to the time of payment, shall be added and paid.

2. The tax may be paid with uncertified check, during such time and under such regulations as the Tax Commission shall prescribe, but if a check so received is not paid by the bank on which it is drawn, the taxpayer by whom such check is tendered shall remain liable for the payment of the tax and for all legal penalties, the same as if such check had not been tendered.

Sec. 501. *Examination of returns.* 1. As soon as practicable after the return is filed the Tax Commission shall examine it and compute the tax, and the amount so computed by the Tax Commission shall be the tax. If the tax found due shall be greater than the amount theretofore paid, the excess shall be paid to the Tax Commission within ten days after notice of the amount shall be mailed by the Tax Commission, and any overpayment of tax shall be returned within ten days after it is ascertained.

2. If the return is made in good faith and the understatement of the tax is not due to any fault of the taxpayer, there shall be no penalty or additional tax added because of such under-

statement, but interest shall be added to the amount of the deficiency at the rate of one per cent for each month or fraction of a month.

3. If the understatement is due to negligence on the part of the taxpayer, but without intent to defraud, there shall be added to the amount of the deficiency five per cent thereof, and in addition, interest at the rate of one per cent per month or fraction of a month.

4. If the understatement is false or fraudulent, with intent to evade the tax, the tax on the additional income discovered to be taxable shall be doubled and an additional one per cent per month or fraction of a month shall be added.

5. The interest provided for in this section shall in all cases be computed from the date the tax was originally due to the date of payment.

6. If the amount of tax found due as computed shall be less than the amount theretofore paid, the excess shall be refunded by the Tax Commission out of the proceeds of the tax retained by it as provided in this act.

Sec. 502. Corrections and changes. If the amount of the net income for any year of any taxpayer under this article as returned to the United States Treasury Department is changed or corrected by the Commissioner of Internal Revenue or other office of the United States or competent authority, such taxpayer, within ten days after receipt of notice of such change or correction, shall make return under oath or affirmation to the Tax Commission of such changed or corrected net income, and shall concede the accuracy of such determination or state wherein it is erroneous.

The Tax Commission shall ascertain, from such return and any other information in the possession of the Commission, the entire net income of such taxpayer for the fiscal or calendar year for which such change or correction has been made by such Commissioner of Internal Revenue or other officer or authority. The Tax Commission shall thereupon reaudit and restate the account of such taxpayer for taxes based upon the entire net

income for such fiscal or calendar year, such reaudit to be according to the entire net income so ascertained by the Tax Commission. The proceedings and determination of the Tax Commission in the making of such reassessment may be revised and readjusted and reviewed as in the case of an original assessment of the tax. If from such reassessment it appears that such taxpayer shall have paid under this article an excess of tax for the year for which such reassessment is made, the Tax Commission shall within thirty days refund the amount of such excess. If from such reassessment it appears that an additional tax is due from such taxpayer for such year, such taxpayer shall, within thirty days after notice has been given in by the Tax Commission pay such additional tax.

Sec. 503. *Additional Taxes.* If the Tax Commission discovers from the examination of the return or otherwise that the income of any taxpayer, or any portion thereof, has not been assessed, it may, at any time within two years after the time when the return was made due, assess the same and give notice to the taxpayer of such assessment, and such taxpayer shall thereupon have an opportunity, within thirty days, to confer with the Tax Commission as to the proposed assessment. The limitation of two years to the assessment of such tax or additional tax shall not apply to the assessment of additional taxes upon fraudulent returns. After the expiration of thirty days from such notification the Tax Commission shall assess the income of such taxpayer or any portion thereof which it believes has not theretofore been assessed and shall give notice to the taxpayer so assessed, of the amount of the tax and interest and penalties, if any, and the amount thereof shall be due and payable within ten days from the date of such notice. The provisions of this act with respect to revision and appeal shall apply to a tax so assessed. No additional tax amounting to less than one dollar shall be assessed.

Sec. 504. *Warrant for the collection of taxes.* If any tax imposed by this act or any portion of such tax be not paid within sixty days after the same become due, the Tax Commis-

sion shall issue an order under its hand and official seal directed to the sheriff of any county of the State, commanding him to levy upon and sell the real and personal property of the taxpayer, found within his county, for the payment of the amount thereof, with the added penalties, interest and the cost of executing the same and to return to the Tax Commission the money collected by virtue thereof by a time to be therein specified, not less than sixty days from the date of the order. The said sheriff shall thereupon proceed upon the same in all respects, with like effect, and in the same manner prescribed by law in respect to executions issued against property upon judgments of a court of record, and shall be entitled to the same fees for his service in executing the order, to be collected in the same manner. If an order be returned not satisfied in full, the Tax Commission shall have the same remedies to enforce the claim for taxes against the taxpayer as if the State had recovered judgment against the taxpayer for the amount of the tax.

Sec. 505. *Tax a debt.* Every tax imposed by this act, and all increases, interest and penalties thereon, shall become, from the time it is due and payable, a personal debt, from the person or persons liable to pay the same, to the State of North Carolina.

Sec. 506. *Action for recovery of taxes.* Action may be brought at any time by the Attorney General of the State, at the instance of the Tax Commission, in the name of the State, to recover the amount of any taxes, penalties and interest due under this act.

Sec. 507. *Tax upon settlement of fiduciary's account.* 1. No final account of a fiduciary shall be allowed by the probate court unless such account shows, and the judge of said court finds, that all taxes imposed by the provisions of this act upon said fiduciary, which have become payable, have been paid, and that all taxes which may become due are secured by bond, deposit or otherwise. The certificate of the Tax Commission and the receipt for the amount of the tax therein certified shall

be conclusive as to the payment of the tax, to the extent of said certificate.

2. For the purpose of facilitating the settlement and distribution of estates held by fiduciaries, the Tax Commission, with the approval of the Attorney General, may, on behalf of the State, agree upon the amount of taxes at any time due or to become due from such fiduciaries under the provisions of this act, and payment in accordance with such agreement shall be full satisfaction of the taxes to which the agreement relates.

ARTICLE VI

PENALTIES

Sec. 600. *Penalties.* 1. If any taxpayer, without intent to evade any tax imposed by this act shall fail to file a return of income or pay a tax, if one is due, at the time required by or under the provisions of this act, but shall voluntarily file a correct return of income and pay the tax due within sixty days thereafter, there shall be added to the tax an additional amount equal to five per cent thereof, but such additional amount shall in no case be less than one dollar and an additional one per cent for each month or fraction of a month during which the tax remains unpaid.

2. If any taxpayer fails voluntarily to file a return of income or pay a tax, if one is due, within sixty days of the time required by or under the provisions of this act, the tax shall be doubled, and such doubled tax shall be increased by one per cent for each fraction of a month from the time the tax was originally due to the date of payment.

3. The Tax Commission shall have power, upon making a record of its reasons therefor, to waive or reduce any of the additional taxes or interest provided in subdivisions 1 and 2 of this section, or in subdivisions 2, 3, and 4 of Section 501.

4. If any taxpayer fails to file a return within sixty days of the time prescribed by this act, any judge of the Superior Court, upon petition of the Tax Commission, or of any ten taxable

residents of the State, shall issue a writ of mandamus requiring such person to file a return. The order of notice upon the petition shall be returnable not later than ten days after the filing of the petition. The petition shall be heard and determined on the return day or on such day thereafter as the Court shall fix, having regard to the speediest possible determination of the case, consistent with the rights of the parties. The judgment shall include costs in favor of the prevailing party. All writs and processes may be issued from the clerk's office in any county and, except as aforesaid, shall be returnable as the Court shall order.

5. Any person who, without fraudulent intent, fails to pay any tax or to make, render, sign or verify and return, or to supply any information, within the time required by or under the provisions of this act, shall be liable to a penalty of not more than one thousand dollars, to be recovered by the Attorney General, in the name of the people, by action in any court of competent jurisdiction.

6. Any person or officer or employee of any corporation, or member or employee of any partnership, who, with intent to evade any requirement of this act, or any lawful requirement of the Tax Commission thereunder, shall fail to pay any tax or to make, sign, or verify any return, or to supply any information required by or under the provisions of this act, or who, with like intent, shall make, render, sign, or verify any false or fraudulent return or statement, or shall supply any false or fraudulent information, shall be liable to a penalty of not more than one thousand dollars, to be recovered by the Attorney General in the name of the people, by action in any court of competent jurisdiction, and shall also be guilty of a misdemeanor, and shall, upon conviction, be fined not to exceed one thousand dollars or be imprisoned not to exceed one year, or both, at the discretion of the Court.

7. The Attorney General shall have the power, with the consent of the Tax Commission, to compromise any penalty for which he is authorized to bring action under subdivisions

5 and 6 of this section. The penalties provided by such subdivisions shall be additional to all other penalties in this act provided.

8. The failure to do any act required by or under the provisions of this act shall be deemed an act committed in part at the office of the Tax Commission in Raleigh. The certificate of the Tax Commission to the effect that a tax has not been paid, that a return has not been filed, or that information has not been supplied, as required by or under the provisions of this act, shall be prima facie evidence that such tax has not been paid, that such return has not been filed, or that such information has not been supplied.

9. If any taxpayer who has failed to file a return, or has filed an incorrect or insufficient return, and has been notified by the Tax Commission of his delinquency, refuses or neglects within twenty days after such notice to file a proper return, or files a fraudulent return, the Tax Commission shall determine the income of such taxpayer, according to its best information and belief, and assess the same at not more than double the amount so determined. The Tax Commission may, in its discretion, allow further time for the filing of a return in such case.

ARTICLE VII

REVISION AND APPEAL

Sec. 700. *Revision by Tax Commission.* A taxpayer may apply to the Tax Commission for revision of the tax assessed against him, at any time within one year from the time of the filing of the return or from the date of the notice of the assessment of any additional tax. The Tax Commission shall grant a hearing thereon, and if, upon such hearing, it shall determine that the tax is excessive or incorrect, it shall resettle the same according to the law and the facts and adjust the computation of tax accordingly. The Tax Commission shall notify the taxpayer of its determination and shall refund to the taxpayer the amount, if any, paid in excess of the tax found by it to be due.

If the taxpayer has failed, without good cause, to file a return within the time prescribed by law, or has filed a fraudulent return, or, having filed an incorrect return, has failed, after notice, to file a proper return, the Tax Commission shall not reduce the tax below double the amount for which the taxpayer is found to be properly assessed.

Sec. 701. *Appeal.* Any taxpayer may file formal exceptions to any findings by the State Tax Commission with respect to his taxable income, and upon such exceptions being overruled, any such taxpayer shall have the right, upon the payment of the amount of tax found by the State Tax Commission to be due, and upon filing bond for costs in the sum of two hundred dollars, to have the record in such case certified to the Superior Court of the county in which the taxpayer resides, or has his principal place of business, within thirty days after notice by the Tax Commission of its determination, given as provided in section 700 of this act. Thereupon, appropriate proceedings shall be had and the relief, if any, to which the taxpayer may be found entitled may be granted and any taxes, interest or penalties paid, found by the Court to be in excess of those legally assessed, shall be ordered refunded to the taxpayer, with interest from time of payment.

The General Assembly of North Carolina do enact:

Section 1. That in determining the taxable income of a corporation engaged in the business of operating a railroad under section two hundred and two of the act to raise revenue, in the case of a railroad located entirely within this State, the net operating income shall be increased or decreased to the extent of any credit or debit balance received or paid, as the case may be, on account of car hire; and when any railroad is located partly within and partly without this State, then said net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid, as the case may be, on account of car hire.

TRANSCRIPT OF RECORD.

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1922.

No. 744.

SEABOARD AIR LINE RAILWAY COMPANY, APPELLANT,

vs.

**A. D. WATTS AND A. D. WATTS, AS COMMISSIONER
OF REVENUE OF THE STATE OF NORTH CAROLINA,
ET AL.**

**APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR
THE EASTERN DISTRICT OF NORTH CAROLINA.**

FILED DECEMBER 18, 1922.

(29,294)

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TRANSCRIPT OF RECORD.

In the District Court of the United States for the Eastern District of North Carolina.

At a District Court of the United States for the Eastern District of North Carolina begun and held at the court-house, in the city of Raleigh, on the fourth Monday after the fourth Monday in October, being the 20th day of November, in the year of our Lord one thousand nine hundred and twenty-two.

Present: The Honorable Henry G. Connor, Judge of the District Court for the Eastern District of North Carolina.

Among others were following proceedings, to-wit:

In Equity.

SEABOARD AIR LINE RAILWAY COMPANY

vs.

A. D. WATTS, Individually and as Commissioner of Revenue of North Carolina, et al.

2

Bill of Complaint.

Filed March 9th, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 447.

SEABOARD AIR LINE RAILWAY COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina; BENJAMIN R. Lacy, State Treasurer of North Carolina; Baxter Durham, State Auditor of North Carolina, and James S. Manning, Attorney General of North Carolina, Defendants.

To the Honorable H. G. Connor, Judge of the District Court of the United States for the Eastern District of North Carolina:

Seaboard Air Line Railway Company, a corporation duly organized and existing under the laws of the States of Virginia, North Carolina and South Carolina, and a citizen of the said states, brings

this, its Bill of Complaint against A. D. Watts, Commissioner of Revenue of North Carolina, a citizen of the State of North Carolina, whose official residence as Commissioner of Revenue of North Carolina is at the city of Raleigh in said state and in the Eastern District thereof, and Benjamin R. Lacy, Treasurer of the State of North Carolina and a citizen and resident of the county of Wake in the Eastern District of said state, and Baxter Durham, Auditor of the State of North Carolina, and a citizen and resident of the county of Wake in the Eastern District of said state, and James S. Manning, Attorney General of the State of North Carolina and a citizen and resident of the county of Wake in the Eastern District of said state.

And complainant respectfully represents that:

1. The complainant is now, and was at all times hereinafter mentioned, a corporation duly organized and existing under the laws of Virginia, North Carolina and South Carolina, and it now does, and did at such other times hereinafter mentioned, own, operate, manage and control lines of railroad and other property in connection therewith in and through the states of Virginia, North Carolina, South Carolina, Georgia, Florida and Alabama, and it is now, and was at all such other times, engaged in operating said lines of railroad in interstate commerce.

2. The defendant, A. D. Watts, is Commissioner of Revenue of the State of North Carolina, duly appointed by the Governor of North Carolina, and under and by virtue of Chapter 40 of the Public Laws of North Carolina of 1921, and duly qualified under the laws of said state, and is a citizen of North Carolina, whose official residence as Commissioner of Revenue is at the city of Raleigh, in said state and in the Eastern District thereof; that the defendant, Benjamin R. Lacy, is the State Treasurer of the State of North Carolina, duly elected and qualified under the laws of said state, and is a citizen and resident of the county of Wake in the Eastern District of said state; that the defendant, Baxter Durham, is the State Auditor of the State of North Carolina, and a citizen and resident of the county of Wake in the Eastern District of said state; that the defendant, James S. Manning, is Attorney General of the State of North Carolina, and a citizen and resident of the county of Wake in the Eastern District of said state. The said defendants, A. D. Watts, Benjamin R. Lacy, Baxter Durham and James S. Manning, are charged with the duty of levying, assessing and collecting the tax which the State of North Carolina asserts is due to it by the complainant. More particular reference to the tax involved in this suit will presently be made.

3. This is a suit in equity and arises under the Constitution and laws of the United States, as will presently more fully appear, and the amount in controversy, exclusive of interest and costs as will hereinafter be specifically shown, exceeds the sum and value of Three Thousand Dollars (\$3,000.00). The complainant brings this suit to restrain the defendants from levying, assessing and collecting certain taxes upon the complainant and its property.

in North Carolina under color of the several statutes of North Carolina hereinafter mentioned. The complainant respectfully shows that unless the defendants and all of them be restrained from enforcing collection of said taxes, it will be deprived by privileges and immunities guaranteed and secured to it by the Constitution of the United States and the Fourteenth Amendment thereof; and further, that it will be deprived of its property without due process of law and will likewise be denied the equal protection of the law, in contravention of the Constitution of the United States and the Fourteenth Amendment thereof. The complainant also shows that the taxes sought to be imposed by virtue and under the authority of the North Carolina statutes constitute a direct burden upon interstate commerce in violation of the Commerce Clause of the Federal Constitution.

4. The complainant shows that the provisions of the Constitution of North Carolina, Article 5, Section 3, authorizing the levy of an income tax on itself and other railroad corporations are as follows:

Taxation Shall be by Uniform Rule and ad Valorem—Exemptions.—Laws shall be passed by taxing, by a uniform rule, all moneys, credits, investments in bonds, stocks, joint-stock companies, or otherwise; and, also, all real and personal property, according to its true value in money: Provided, notes, mortgages, and all other evidence of indebtedness given in good faith for the purchase price of a home, when said purchase price does not exceed three thousand dollars, and said notes, mortgages, and other evidence of indebtedness shall be made to run for not less than five nor more than twenty years, shall be exempt from taxation of every kind; Provided, that the interest carried by such notes and mortgages shall not exceed five and one-half per cent. The general assembly may also tax trades, professions, franchises, and income: 'Provided, the rate of tax on income shall not in any case exceed six per cent (6%), and there shall be allowed the following exemptions, to be deducted from the amount of annual incomes, to wit: for a married man with a wife living with him, or to a widow or widower having minor child or children, natural or adopted, not less than \$2,000; to all other persons not less than \$1,000, and there may be allowed other deductions (not including living expenses) so that only net incomes are taxed.'"

5. The complainant shows that the Legislature of North Carolina, at its regular session of 1921, purporting to act under the authority of the provision of the constitution above quoted, enacted a law providing for the levying, collecting and paying of an income tax on individuals and corporations, the said law forming a part of the Revenue Act of 1921, being Chapter 34 of the Public Laws of North Carolina of 1921. It is provided by Section 100 of said Revenue Act that the income tax schedule should be known and cited as the Income Tax Act of 1921, and said act will be so referred to in this bill of complaint.

6. Section 101 of the Income Tax Act of 1921, as amended by the General Assembly of North Carolina, Special Session of 1921, is as follows:

"Sec. 101. Purpose.—The general purpose of this act is to impose a tax, for the use of the State Government, upon the net income for the calendar year 1921, in excess of exemptions herein set out, collectible in the year 1922, and annually thereafter:

(a) Of every citizen of the State.

(b) Of every domestic corporation.

6 (c) Of every foreign corporation and of every nonresident individual having a business or agency in this State, in proportion to the net income of such business or agency.

Except as otherwise provided in this act the purpose is to conform to the definitions of income in the revenue laws of the United States Government and regulations made under its authority, in so far as they apply.

The Tax imposed upon the net income of corporations in this schedule is in addition to the tax imposed under Schedule C of this Act."

7. Section 201 of the Income Tax Act of 1921, as amended by the General Assembly of North Carolina, Special Session of 1921, is as follows:

"Sec. 201. Corporations.—Every corporation organized under the laws of this State shall pay annually an income tax equivalent to three per cent of the entire net income of such corporation, as herein defined, received by such corporation during the income year; and every foreign corporation doing business in this State shall pay annually an income tax equivalent to three per cent of a proportion of its entire net income, to be determined according to the following rules:

In case of a company other than companies mentioned in the next succeeding section, deriving profits principally from the ownership, sale, or rental of real estate or from the manufacture, sale, or use of tangible personal property, such proportion of its entire net income as the fair cash value of its real estate and tangible personal property in this State on the date of the close of the fiscal year of such company in the income year is to the fair cash value of its entire real estate and tangible personal property then owned by it, with no deduction on account of incumbrances thereon.

7 In case of a corporation deriving profits principally from the holding or sale of intangible property, such proportion as its gross receipts in this State for the year ended on the date of the close of its fiscal year next preceding is to its gross receipts for such year within and without the State."

8. Section 202 of the Income Tax Act of 1921 is as follows:

"Sec. 202. Railroads and Public Service Corporations.—The basis of ascertaining the net income of every corporation engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service, when

such company is required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, shall be the 'net operating income' of such corporations as shown by their records kept in accordance with that standard classification of accounts, when their business is wholly within this State, and when their business is in part within and in part without this State, including in their gross 'operating revenues' within this State the equal mileage proportion within this State of their interstate business and deducting from their gross 'operating revenues' the proportionate average of 'operating expenses,' or 'operating ratio,' for their whole business, as shown by the Interstate Commerce Commission standard classification of accounts. From the net operating income thus ascertained shall be deducted 'uncollectible revenue,' and taxes paid in this State for the income year other than income taxes and war profits and excess profits taxes, and the balance shall be deemed to be their net income taxable under this act."

9. The foregoing section relating to the basis of ascertaining the net incomes of railroads was supplemented by Chapter 35 of the Public Laws of 1921, as follows:

8 "Section 1. That in determining the taxable income of a corporation engaged in the business of operating a railroad under section two hundred and two of the act to raise revenue, in the case of a railroad located entirely within this State, the net operating income shall be increased or decreased to the extent of any credit or debit balance received or paid, as the case may be, on account of car hire; and when any railroad is located partly within and partly without this State, then the said net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid, as the case may be, on account of car hire."

10. Section 203 of the Income Tax Act of 1921, as amended by Chapter 35, Public Laws of 1921, is as follows:

"Sec. 203. Such tax shall first be levied, collected, and paid in the year 1922, and with respect to the net income received during the calendar year 1921 and annually thereafter."

11. Section 3 of Chapter 34, Public Laws of 1921, provides:

"No tax on any property in the State shall be levied for any of the uses of the State Government. The taxes hereinafter levied in this act are for the expenses of the State Government, the appropriations to its educational, charitable and penal institutions, pensions for Confederate Soldiers and widows, the interest on the debt of the State, an equalizing fund for public schools, and other specific appropriations made by law, and shall be collected and paid into the general fund of the State Treasurer."

12. Complainant shows that the said Income Tax Act of 1921 is unconstitutional and void in its application to complainant and other railroads for the following reasons:

(a) For that it is not a tax on income as authorized in Article 5, Section 3, of the Constitution of North Carolina, but is in truth and in fact a tax upon operating income derived by railroad companies from interstate and intrastate commerce, and for the reason that from the operating revenue arrived at under the said law there are not allowed many of the deductions required by the standard classification of Accounts of the Interstate Commerce Commission, which Standard Classification of Accounts was promulgated by the said Interstate Commerce Commission under the provisions of the Interstate Commerce Act passed by Congress, and which are so regulated as to ascertain what is the net income of railroads engaged in interstate commerce. Complainant says that among other items which are directed to be deducted by railroads in interstate commerce from operating income, in order to arrive at net income, are the following:

- Joint Facility Rents;
- Rent for Leased Roads;
- Miscellaneous Rents;
- Miscellaneous Tax Accruals;
- Separately Operated Properties—Loss;
- Interest on Funded Debt;
- Interest on Unfunded Debt;
- Amortization of Discount on Funded Debt;
- Maintenance of Investment Organization;
- Income Transferred to Other Companies;
- Miscellaneous Income Charges;

and avers that in order to ascertain the net income of railroad companies engaged in business in interstate commerce, as complainant is, according to said Standard Classification of Accounts of the Interstate Commerce Commission, promulgated as aforesaid, it is necessary to deduct the above items.

(b) The method of arriving at net income does not result in the ascertainment of net income as the same is defined and arrived at under the Standard Classification of Accounts of the Interstate Commerce Commission, in that the Standard Classification of Accounts directs that there shall be deducted from the net operating income not only the deductions provided for in said law of North Carolina, but in addition thereto the following:

- Joint Facility Rents;
- Rent for Leased Roads;
- Miscellaneous Rents;
- Miscellaneous Tax Accruals;
- Separately Operated Properties—Loss;
- Interest on Funded Debt;
- Interest on Unfunded Debt;

Amortization of Discount on Funded Debt;
Maintenance of Investment Organization;
Income Transferred to Other Companies;
Miscellaneous Income Charges.

The result is that the machinery provided for by the said statute for the ascertainment of net income does not in truth and in fact produce net income, which under Section 101 is declared to be the purpose of the said act to tax. Furthermore, the method outlined in said law for arriving at net income produces a figure which is not the true net income, but which contains in part gross income, and in so far as it does include gross income, which gross income is derived from interstate commerce, said tax is a direct burden upon interstate commerce and is void under the Commerce Clause of the Constitution of the United States.

(c) Complainant further says that the said statute is unconstitutional and void for that by Section 306 it permits corporations other than the corporations named in Section 202 to deduct:

1. All the ordinary and necessary expenses paid during the income year in carrying on any trade or business, including:

(a) As to individuals, wages of employees for services actually rendered in producing such income.

(b) As to partnerships, wages of employees and a reasonable allowance for co-partners or members of a firm, for services actually rendered in producing such income, the amount of such salary allowance to be included in the personal return of the co-partner receiving same.

(c) As to corporations, wages of employees and salaries of officers, if reasonable in amount, for services actually rendered in producing such income.

(2) Rentals or other payments required to be made as a condition of the continued use or possession, for the purposes of the trade of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

(3) All interest paid during the income year on indebtedness except interest on obligations contracted for the purchase of non-taxable securities. Dividends on preferred stock shall not be deducted as interest.

(4) Taxes for the income year, except taxes on income and war profits, and excess profits taxes, inheritance taxes, and taxes assessed for local benefit of a kind tending to increase the value of the property assessed.

(5) Dividends from stock in any corporation, the income of which shall have been assessed and the tax on such income paid by the corporation under the provisions of this act: Provided, that when only part of the income of any corporation shall have been assessed

under this act only a corresponding part of the dividends received therefrom shall be deducted.

(6) Losses sustained during the income year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit.

(7) Debts ascertained to be worthless and charged off within the income year, if the amount has previously been included in gross income in a return under this act.

(8) A reasonable allowance for the depreciation and obsolescence of property used in the trade or business; and, in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion: Provided, that in computing the deduc-

12 tions allowed under this paragraph, the basis shall be the cost (including in the case of mines, oil and gas wells, and other natural deposits, the cost of development, not otherwise deducted), and in the case of property acquired prior to January 1st, 1921, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date. The reasonable allowances under this paragraph shall be made under rules and regulations to be prescribed by the Tax Commission. In the case of leases, the deductions allowed may be equitably apportioned between the lessor and lessee.

(9) In the case of taxpayers who keep regular books of account upon an accrual basis and in accordance with standard accounting practice, reserves for bad debts and for contingent liabilities, under such rules and restrictions as the Tax Commission may impose. If the Tax Commission shall at any time deem the reserve excessive in amount, it may restore such excess to income, either in a subsequent year or as a part of the income of the income year and assess it accordingly.

(10) Contributions or gifts made within the taxable year to corporations or associations operated exclusively for religious, charitable, scientific or educational purposes or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, to an amount not in excess of fifteen per centum on the taxpayer's net income as computed without the benefit of this subdivision.

(11) Resident individuals having an established business in another state, or investment in property in another state, may deduct the net income from such business or investment, if such business or investment is in a state that levies a tax upon such net income. The deduction authorized by this subsection shall in no case extend to any part of income of resident individuals from personal services, or mortgages, stocks, bonds, securities and deposits.

13 (12) In the case of a nonresident individual, the deductions allowed in this section shall be allowed only if, and to the extent that, they are connected with income arising from sources

within the state; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the state shall be determined under rules and regulations prescribed by the State Tax Commission.

13. The said Income Tax Act of 1921, in violation of the Constitution of North Carolina and the Constitution of the United States, creates a discrimination against complainant and other railroad companies of similar character in favor of other corporations and individuals in that the said act in order to ascertain the taxable income allows other corporations and individuals certain deductions, many of which said deductions are not allowed to complainant and other railroad corporations of similar character.

14. Complainant shows that under the provisions of the Income Tax Act of 1921, and particularly Section 202, Section 300, and Section 306, all corporations except railroads and public service corporations which are required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, are required to pay a tax on their net income, which is defined by Section 300 as "the gross income of a taxpayer, less the deductions allowed by this act," whereas complainant and other railroads and public service corporations which are required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, are not allowed the deductions set forth in the said act, except, "uncollectible revenue" and taxes paid in the State for the income year other than income taxes, war profits and excess profits taxes, and certain deductions for car hire, and complainant shows that it and other railroad companies and public service corporations of similar character referred to in Section 202 of the

Income Tax Act of 1921 are denied large deductions which
14 are granted other corporations, individuals and railroads not included in the provisions of Section 202, and particularly the deduction of interest paid during the income year, which results in discrimination against the complainant, in violation of the Constitution of North Carolina, and denies the complainant the equal protection of the law and deprives it of its property without due process of law in contravention of the Fourteenth Amendment of the Constitution of the United States.

15. Complainant shows that the said Income Tax Act of 1921 does not operate equally and uniformly upon all taxpayers in similar circumstances, and that the complainant and other railroads and public services corporations, which are required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, have been arbitrarily selected and taxed upon a more burdensome basis and one that is different from that applied to corporations in general and to other corporations engaged in business similar to that of complainant in violation of the Constitution of North Carolina and complainant is thereby denied the equal protection of the law and is deprived of its property without due process

of law in contravention of the Fourteenth Amendment of the Constitution of the United States.

16. Complainant shows that the income tax levied by the said Income Tax Act of 1921 is not levied by a uniform rule as required by the Constitution of North Carolina, Article 5, Section 3, and the lack of uniformity works greatly to the detriment of complainant in violation of said Article 5, Section 3, of the Constitution of North Carolina and denies the complainant the equal protection of the law and deprives it of its property without due process of law in contravention of the Fourteenth Amendment of the Constitution of the United States.

17. Complainant shows that the classification of taxpayers for the purpose of fixing the income on which the tax shall be paid as made by the said Income Tax Act of 1921 is not based upon any reasonable ground, but is a mere arbitrary selection so far as complainant and railroad companies of similar character are concerned and so far as the corporations set forth in Section 202 are concerned, and was made for the purpose and has the result of imposing upon such railroad companies and corporations, including complainant, an unjust burden of taxation, in violation of the Constitution of North Carolina, and denies the complainant the equal protection of the law and deprives it of its property without due process of law in contravention of the Fourteenth Amendment of the Constitution of the United States.

18. Complainant shows that the method of fixing its taxable income as provided by Section 202 of the said Income Tax Act of 1921 violates the Constitution of North Carolina and the Constitution of the United States, because it does not apply to railroads and public service corporations which derive their income from sources other than the operation of their property, which results in a lack of uniformity in the application of the income tax and in discrimination against complainant, and therein denies the complainant the equal protection of the law and deprives it of its property without due process of law in contravention of the Fourteenth Amendment of the Constitution of the United States.

19. Complainant shows that the tax imposed upon complainant by Section 202 of the Income Tax Act of 1921 is unconstitutional and void because the authority of the Legislature of North Carolina to tax incomes is derived from Section 3, Article 5, of the Constitution of North Carolina, and said section provides that only net incomes may be taxed, and in attempting to tax the "operating revenues" of complainant, the said act violates the Constitution of North Carolina and denies the complainant the equal protection of the law and deprives it of its property without due process of law in contravention of the Fourteenth Amendment of the Constitution of the United States.

20. Complainant further shows that the statute is violative of Article 5, Section 3, of the Constitution of North Carolina, for that

does not levy upon railroads and other public service corporations named in said Section 202, a tax on net income, but levies a tax upon operating revenue derived from interstate and intrastate commerce, and does not permit the deductions necessary and incidental to the business of complainant and expended by it from said income in order to determine net income, and is in violation of the Interstate Commerce Clause (Section 8, Article 1) of the Constitution of the United States, in that it permits a tax as an income tax to be placed on gross income derived from interstate commerce, thereby burdening interstate commerce.

21. Complainant shows that the income tax act of 1921 violates the Transportation Act of Congress and the Interstate Commerce Act, in that it seeks to prescribe a method of accounting by this interstate carrier, when said Acts of Congress have delegated the power to prescribe said accounting to the Interstate Commerce Commission and the said Commission has prescribed and directed that this plaintiff and other interstate carriers keep their accounts in accordance with the methods so prescribed by it.

22. Complainant shows that the State of North Carolina, by its tax laws, permits the counties, cities, towns, townships and special taxing districts to levy taxes on the assessed value of complainant's property known as an ad valorem tax, which is based upon the whole property of complainant, tangible and intangible, and to this the tax laws of the State add a so-called franchise tax of one-tenth of one per cent on the same assessed value, and by the statutes hereinbefore referred to, the Legislature of North Carolina has levied, and unless restrained the defendants in this action will undertake to collect an additional tax characterized as an income tax of three per cent on complainant's net operating revenue, including revenue derived from interstate commerce, and complainant avers that this system of pyramiding taxes and the entire scheme of taxation amounts to a regulation of commerce between the states, because necessarily a tax of one-tenth of one per cent upon the tangible and intangible property of this complainant and a tax of three per cent upon its net operating revenue, including revenue derived from interstate commerce, are taxes upon interstate commerce, the property, tangible and intangible, having already been taxed at its full value, and complainant shows that this scheme of taxation levies a tax and burden upon the interstate commerce of complainant and violates the Commerce Clause of the Constitution of the United States, Section 8 of Article 1.

23. The complainant further shows that the statutes imposing an income tax upon complainant are unconstitutional and void in that they are violative of the scheme of taxation created and made mandatory by the Constitution of North Carolina. That instrument provides a dual system of taxation, one set of taxes being leviable by the State and the other by the counties, and other governmental subdivisions. The complainant, therefore, avers that the scheme of taxation brought about by the tax laws of the State of North Carolina by which

the State derives its entire revenue from taxes other than a tax on property is unwarranted by the Constitution of North Carolina, which by its mandate requires that all property shall bear its just proportion of the burden of taxation and that laws shall be passed taxing by uniform rule all moneys, credits, investments in bonds, stocks, joint stock companies or otherwise, and also all real and personal property according to its true value in money, (Article 5, Section 1) and the complainant shows that the North Carolina Legislature has no power to exempt a large class of property from liability to taxation for state purposes as is done by Section 3, Chapter 34 of the Public Laws of 1921, and recoup the loss of revenue thereby occasioned by taxes other than a tax on property. Such method

18 or scheme of taxation is plainly at variance with that established by the Constitution of North Carolina, and consequently Section 202, which attempts to impose a part of this additional burden of taxation upon the complainant, is void, in that it violates the Constitution of North Carolina and denies the complainant the equal protection of the laws and deprives the complainant of its property without due process of law in violation of the Fourteenth Amendment of the Constitution of the United States, and complainant further shows that the said scheme of taxation is unconstitutional and void in that the complainant is charged with an undue proportion of the expenses of the state government and a greater proportion of the burden of taxation than is warranted by the Constitution of North Carolina in that Complainant is required by the tax laws of North Carolina to pay to counties, cities and towns and special tax districts large sums as taxes on the assessed value of its property and in addition thereto a so-called franchise tax of one-tenth of one per cent on its assessed value of \$34,768,440.00 and an income tax of three per cent on its net operating revenue.

24. Complainant further shows that said tax for the calendar year 1921 is unconstitutional and void because it is retroactive to the extent that it attempts to tax income for the months of January, February and eight days in the month of March, 1921, the said act having been ratified March 8th, 1921, and being effective from the date after its ratification.

25. Complainant shows that a form for the income tax returns for the calendar year ending December 31st, 1921, copy of which is attached hereto as part of this bill of complaint, has been received by complainant which requires said return to be made in conformity with the provisions of Section 202 of the Income Tax Act of 1921 and complainant is required by law to file said return with the Commissioner of Revenue on or before March 15th, 1922, and said return will show \$437,769.52 as the amount on which complainant

19 will be taxed at the rate of three per cent, whereas, if complainant were allowed the deductions to which it is entitled it would not have any taxable income because the sum of such deductions is greater than the taxable income shown on the said return and the tax which complainant will be called on to pay to the State of North Carolina on or after March 15th, 1922, is \$13,133.09,

unless the defendants are restrained and enjoined from doing so, they will proceed on or after March 15th, 1922, to assess said tax and collect same from complainant. It is further shown that under the laws of North Carolina the said tax will become a lien upon the property of complainant and will be a cloud upon its title, and the enforcement of said tax by execution would interfere with the conduct of complainant's business as an interstate carrier, and it is further shown that, upon the collection of said tax, the amount thereof will pass into the Treasury of the State of North Carolina, and complainant is without remedy by which it can obtain refund thereof, all to the irreparable damage of complainant, and for which it has no adequate remedy at law.

26. The complainant shows that Section 600 of the said Income Tax Act of 1921 imposes certain penalties upon a taxpayer who fails to pay the taxes levied by the said act, such penalties being among other things double the amount of the tax. The complainant avers that such penalties are excessive, unreasonable, oppressive and inequitable and that it is a denial of due process of law for the said act to impose such penalties upon the complainant, who is proceeding with reasonable diligence to have it judicially determined whether or not the said Act is valid, the complainant in good faith asserting that said act is not valid. The complainant therefore avers that even though the said Act should finally be declared valid the said penalties ought not to be imposed upon the complainant.

Prayer.

Wherefore, and for as much as complainant is remediless in the premises, according to the common law, and remediable only in equity, and that complainant may not suffer irreparable injury and damage, and may be permitted to pursue and carry on its business without unlawful hindrance and destruction, and that the railroads by complainant operated in the State of North Carolina as aforesaid and its other property herein may not be subjected to illegal liens and clouds, complainant prays for a writ of subpoena to issue against the defendants and each and every one of them and described as aforesaid, to appear and full and true answer make to this bill of complaint, but not under oath, answer under oath being waived, and that said defendants, and each and every one of them, be enjoined by final decree, and, meanwhile, by a preliminary injunction as follows, to-wit:

That said A. D. Watts, Commissioner of Revenue of North Carolina, be enjoined and restrained from taking, or causing to be taken, any action towards enforcing the tax, or any part thereof, which the said Income Tax Act of 1921 imposes upon the complainant or its property in the State of North Carolina.

That Baxter Durham, as Auditor of North Carolina, be enjoined and restrained from charging to complainant for collection and that Benjamin R. Lacy, as State Treasurer, be enjoined and restrained from collecting from complainant the tax or any part thereof imposed by said act.

That James S. Manning, as Attorney General of North Carolina be enjoined and restrained from instituting or authorizing the institution of any suit or proceedings to collect the said tax.

Complainant further prays that the tax statutes of North Carolina herein alleged to be unlawful be decreed by this Court to be unconstitutional and invalid, and that no assessment for taxation be made against the complainant thereunder, and no tax be levied against the complainant thereunder, and that no penalties be inflicted upon the complainant under the said Act, and for all such other, further, general and special relief which in equity it may be entitled.

This is the first application for injunction in this cause.

MURRAY ALLEN,
Solicitor for Complainant

FORNEY JOHNSTON,
JAMES F. WRIGHT,
Of Counsel.

STATE OF VIRGINIA,
City of Portsmouth:

J. S. Hamilton, being duly sworn, deposes and says that he is an officer of Seaboard Air Line Railway Company, to-wit: Assistant Comptroller; that he has read the foregoing bill of complaint and knows the contents thereof; that the same is true of his own knowledge, except as to matters therein stated on information and belief and as to these matters he believes it to be true.

J. S. HAMILTON,
Assistant Comptroller.

Subscribed and sworn to before me this 8th day of March, 1924.

JNO. H. BOATWRIGHT,
Notary Public.

I hereby certify that this is a case in which, by the laws of Virginia, no tax is required upon the seal.

JNO. H. BOATWRIGHT,
Notary Public.

My commission expires 9th day of February, 1924.

EXHIBIT "A" TO BILL OF COMPLAINT.

Exhibit.

State Department of Revenue.

Public Service Corporation Income Tax Return.

(Railroads.)

For Calendar Year Ending December 31, 1921.

Name, ———.

Business address, ———.

We, the undersigned, president and treasurer of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return, including the accompanying schedules and statements, has been examined by him and is, to the best of his knowledge and belief, a true and complete return made in good faith, for the taxable period as stated, pursuant to the Revenue Act for 1921 and the Regulations issued under authority thereof.

_____,
President._____,
Treasurer.

Sworn to and subscribe before me, this — day of —, 1922.

_____,
(Official capacity.)

*Net operating income (when business is wholly within the State).....	\$.....
*Net operating revenue, including equal mileage proportion within this State of the interstate business (when business is in part within and in part without the State).....	.....
*Other income.....	.....
Total income.....	\$.....
*Operating expenses (when business is wholly within the State).....	.....
*Proportionate average of operating expenses (when business is in part within and in part without the State).....	.....
*Uncollectible revenue.....	.....
Taxes paid in this State, other than income and war profits and excess profits taxes.....	.....
Total deductions.....	\$.....
Operating income, less deductions.....	\$.....

*As per standard Classification of Accounts of Interstate Commerce Commission.

Plus or Minus any credit or debit balance received or paid on account of car hire. And when any railroad is partly within and partly without the State then said net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid.....

\$.....

Net taxable income.....

\$.....

Tax @ 3%.....

\$.....

Main track mileage (system).....

Main track mileage (State).....

23

Railroads and Public-service Corporations; Basis of Ascertain-
taining Net Income.—The basis of ascertaining the net income of every corporation engaged in the business of operating steam or electric railroad, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the standard classification of accounts of the Interstate Commerce Commission, shall be the "net operating income" of such corporations as shown by their records kept in accordance with that standard classification of accounts, when the business is wholly within this State, and when their business is in part within and in part without the State their net income within this State shall be ascertained by taking their gross "operating revenues" within this State, including in their gross "operating revenues" within this State the equal mileage proportion within this State of their interstate business and deducting from their gross "operating revenues" the proportionate average of "operating expenses," or "operating ratio," for their whole business, as shown by the Interstate Commerce Commission standard classification of accounts. From that net operating income thus ascertained shall be deducted "uncollectible revenue," and taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes, and the balance shall be deemed to be their net income taxable under this act.

Car Hire Considered.—In determining the taxable income of a corporation engaged in the business of operating a railroad under the preceding section, in the case of a railroad located entirely within this State, the net operating income shall be increased or decreased to the extent of any credit or debit balance received or paid, as the case may be, on account of car hire; and when any railroad is located partly within and partly without this State, then said net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid, as the case may be, on account of car hire.

24

Application for Interlocutory Injunction.

Filed March 9, 1922.

In Equity.

#447.

SEABOARD AIR LINE RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et als.

Comes the above named plaintiff and shows the Court:

That it has instituted in this Court by bill of complaint an action against A. D. Watts, as Commissioner of Revenue of the State of North Carolina, and other defendants as shown in said bill which is now referred to and made a part of this application, the object and purpose of the action being to secure from this Honorable Court an order enjoining preliminarily and perpetually the defendants, who are tax assessing, collecting and enforcing officers, of the State of North Carolina, from collecting or instituting proceedings to collect an income tax on the net operating revenue of complainant under statutes which complainant alleges to be violative of the Constitution of North Carolina and the Constitution of the United States. The bill alleges and sets forth the grounds of unconstitutionality of the said income tax and of the Statutes of North Carolina under which said tax is assessed and under which it will be collected by the defendants named in said bill, unless restrained by this Honorable Court, all of which is more fully alleged, set out, and explained in the bill of complaint filed herein. Complainant alleges that said income tax is invalid and the statutes under which it is levied are in contravention of the Constitution of North Carolina, and the Constitution of the United States, and unless the defendants are restrained and enjoined from so doing, they will proceed on or after March 15th, 1922, to levy and collect said tax.

Wherefore, application is made under Section 266 of the Judicial Code for an interlocutory injunction as prayed for in said bill, and this Court is petitioned to call to his assistance to hear and determine this application two other judges, and that the statutory notice of the hearing of this application be given the Governor and the Attorney General of the State of North Carolina and each of the defendants to the said bill, and an order issued requiring the defendants to show cause at the time and place to be fixed by this Court according to law why said interlocutory injunction should not issue as prayed for.

This application is based upon the verified bill of complaint on file herein.

MURRAY ALLEN,
Solicitor for Complainant.

26 *Order on Application for Interlocutory Injunction.*

Filed March 9th, 1922.

In the District Court of the United States for the Eastern District of
North Carolina.

In Equity.

No. 447.

SEABOARD AIR LINE RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.

The application for an interlocutory injunction was presented to me this 9th day of March, 1922, and having read and considered the verified bill filed in this cause, and the application for interlocutory injunction under Section 266 of the Judicial Code, and being advised that for the reasons set forth in said application and upon the grounds stated therein and in the verified bill, complainant is entitled to have its application heard under section 266 of the Judicial Code:

It is ordered that the application be filed and a hearing of the application for an interlocutory injunction be had and proceeded with in accordance with Section 266 of the Judicial Code as amended by Act of Congress approved March 14th, 1913, and such hearing is set down for 15th day of March, 1922, at the United States Court room in the City of Raleigh, North Carolina, at 12 o'clock M.

It is further ordered that notice of said hearing, not less than five days, shall be given to the Governor and Attorney General of the State of North Carolina and to each of the defendant-. And I hereby call to my assistance at the hearing of said application the Hon. Edmund Waddill, Circuit Judge of this Circuit, and the Hon. James E. Boyd, District Judge of the Western District of North Carolina.

This 9th day of March 1922, at Raleigh, N. C.

H. G. CONNOR,
District Judge.

27 *Notice of Hearing of Application for Interlocutory Injunction.*

Filed March 9, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 447.

SEABOARD AIR LINE RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et als.

To Honorable Cameron Morrison, Governor of the State of North Carolina; Honorable James S. Manning, Attorney General of North Carolina; Honorable A. D. Watts, Revenue Commissioner of the State of North Carolina; Honorable Baxter Durham, Auditor of the State of North Carolina, and Honorable Benjamin R. Lacy, Treasurer of the State of North Carolina:

You, and each of you, are hereby notified that the Seaboard Air Line Railway Company, complainant, has filed its verified bill of complaint in the District Court of the United States for the Eastern District of North Carolina against A. D. Watts, Revenue Commissioner, et als., praying an injunction against the named tax assessing, collecting and enforcing officers of the State of North Carolina from instituting proceedings to collect an income tax upon complainant's net operating revenue under the Income Tax Act of 1921 of North Carolina, and also praying that the laws of North Carolina levying said tax be declared unconstitutional, as will appear from the bill filed herein.

In this case plaintiff has made application for an interlocutory injunction under Section 266 of the Judicial Code of the United States.

The application for such interlocutory injunction will be heard in the United States District Court, in the City of Raleigh, North Carolina, on the 15th day of March, 1922, at 12 o'clock M., and you, and each of you, are notified to appear at said time and place and show cause, if any, why the interlocutory injunction prayed for should not be granted.

Done in open Court this 9th day of March, 1922.

H. G. CONNOR,
District Judge.

Return on Notice of Hearing.

Filed March 13, 1922.

Received March 10, 1922, executed March 10, 1922 by delivering a copy of this order to show cause to the following: A. D. Watts, Benjamin R. Lacy, Baxter Durham and Gov. Cameron Morrison.

R. W. WARD,

U. S. Marshal,

By JOHN R. WILLIAMS,

Deputy United States Marshal.

Fees \$8.00.

Service of within notice accepted and copy received this March 9th, 1922.

JAMES S. MANNING,

*Attorney General of North Carolina.**Affidavit of M. S. Hawkins.*

Filed Mar. 16, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 447.

SEABOARD AIR LINE RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue, et als.

M. S. Hawkins, being first duly sworn, deposes and says that he is Secretary of Norfolk Southern Railroad Company: that Norfolk Southern Railroad Company is a corporation originally created, organized and existing under the laws of the State of Virginia, and operates a line of railroad located partly in Virginia and partly in North Carolina and, in addition, during the year 1921, had, and now has, under lease a line of railroad owned by the Atlantic & North Carolina Railroad Company, extending from Goldsboro to Morehead City, and also a lease of the Durham & South Carolina Railroad, extending from Duncan to Durham, and under lease the Carthage & Pinehurst Railroad, extending from Pinehurst to Carthage;

That the line of railroad owned by the Atlantic & North Carolina Railroad Company was held under lease made by the Atlantic & North Carolina Railroad Company to the Howland Improvement Company, bearing date the 1st day of September, 1904, for a term of ninety-one years and four months from the said date, and to

fully ended and completed, commencing the 1st day of September, 1904;

That Norfolk Southern Railroad Company is the successor by assignments and mesne conveyances of said leasehold; that during the year 1921, Norfolk Southern Railroad Company duly paid the rent on said property;

That the Durham & South Carolina Railroad is held under lease bearing date of 27th day of May, 1920, and is for a term of ninety-nine years; that the rent on said property was duly paid for the year 1921;

That the Carthage & Pinchurst Railroad was held under lease made during the period of Federal Control of Railroads and terminated by its terms at the end of Federal Control; that Norfolk Southern Railroad Company continued to operate the same during the year 1921; until it could and did obtain authority from the Interstate Commerce Commission, under the terms of the Transportation Act of 1920, for the cessation of operation of said line of railroad, which authority was duly obtained, and it ceased to operate same in January, 1922.

M. S. HAWKINS.

Sworn and subscribed to before me this 13th day of March 1922.

[SEAL.]

J. R. PRITCHARD,

Notary Public.

My commission expired January 10, 1925.

Affidavit of J. H. Bridgers.

Filed Mar. 16, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 447.

SEABOARD AIR LINE RAILWAY COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, and Others, Defendants.

J. H. Bridgers, being duly sworn, says: That he is President of Henderson Water Company, a corporation incorporated under the laws of the State of North Carolina and engaged in the business of supplying water to the public in the town of Henderson, N. C.; that the said corporation is engaged in public service. That the said corporation is not required to and does not keep its records according to

the standard classification of accounting of the Interstate Commerce Commission. That after making the deductions allowed it under the Income Tax Act of North Carolina of 1921, the said company has no taxable income. That there is attached to this affidavit and made part hereof a duplicate of the income tax return filed by the Henderson Water Company with the Commissioner of Revenue of North Carolina, as required by the Income Tax Act of North Carolina of 1921, upon which said return it appears that the said company after making the deductions allowed corporations under the provisions of the said Income Tax Act, the Henderson Water Company has no taxable income. That there is also attached hereto and made part of this affidavit a form for income tax return by corporations designated in Section 202 of the Income Tax Act, which has been filled out from the books of the Henderson Water Company and which correctly shows the amount of taxable income upon which the said company would be required to pay the income tax if it came within the corporations designated by said Section 202 and was required to keep its accounts according to the standard classification of accounting of the Interstate Commerce Commission, and from which it appears that said corporation would be required to pay an income tax of \$167.23, if its income taxable under the law were required to be determined on the basis of said return.

J. H. BRIDGERS, L.

Subscribed and sworn to before me this 14 day of March, 1922.

[SEAL.]

J. A. SCOTT,
Notary Public.

My Commission expires 2 day of May, 1922.

33

EXHIBIT "A."

Form 8.

State Department of Revenue.

Public-service Corporation Income Tax Return Other Than Railroad

For Calendar Year Ending December 31, 1921.

Name and kind of business, Henderson Water Co.
Business address, Henderson.

We, the undersigned, president and treasurer of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return, including the accompanying schedules and statements, has been examined by him and is, to the best of his knowledge and belief, a true and complete return made in good faith, for the taxable period as stated, pursuant to the

Revenue Act for 1921 and the Regulations issued under authority thereof.

_____,
President.

_____,
Treasurer.

Sworn to and subscribed before me, this — day of —, 1922.

_____,
(Official capacity.)

Operating Revenues, in this State, including mileage proportion of interstate business as per standard Classification of Accounts of Interstate Commerce Commission	\$32,101.83
Operating Expenses, as per standard Classification of Accounts of Interstate Commerce Commission	26,079.00
Net operating revenue	\$6,022.00
All other income .....	.....
Total income	\$6,022.00
Less taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes	771.00
Net taxable income	52.41
Tax @ 3%	\$167.23

34 Railroads and Public-service Corporations; Basis of Ascertaining Net Income.—The basis of ascertaining the net income of every corporation engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, shall be the "net operating income" of such corporations as shown by their records kept in accordance with that standard classification of accounts, when their business is wholly within this State, and when their business is in part within and in part without the State their net income within this State shall be ascertained by taking their gross "operating revenues" within this State, including in their gross "operating revenues" within this State the equal mileage proportion within this State of their interstate business and deducting from their gross "operating revenues" the proportionate average of "operating expenses," or "operating ratio," for their whole business, as shown by the Interstate Commerce Commission standard classification of accounts. From the net operating income thus ascertained shall be deducted "uncollectible revenue," and taxes paid in this

State for the income year, other than income taxes and war profits and excess profits taxes, and the balance shall be deemed to be the net income taxable under this act.

Car Hire Considered.—In determining the taxable income of a corporation engaged in the business of operating a railroad under the preceding section, in the case of a railroad located entirely within this State, the net operating income shall be increased or decreased to the extent of any credit or debit balance received or paid, as the case may be, on account of car hire; and when any railroad is located partly within and partly without this State, then said

35 net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid, as the case may be, on account of car hire.

Form 3.

State Department of Revenue.

Corporation Income Tax Return.

For Calendar Year Ended December 31, 1921.

(Make Affidavit on This Page for Either Blank.)

Kind of business, Henderson Water Co.—Public Water Supply.
 Business address, Henderson, N. C.

We, the undersigned, president and treasurer of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return, including the accompanying schedules and statements, has been examined by him and is, to the best of his knowledge and belief, a true and complete return made in good faith, for the taxable period as stated, pursuant to the Revenue Act for 1921 and the Regulations issued under authority thereof.

(S.)

J. H. BRIDGERS,
President.

(S.)

J. H. BRIDGERS,
Treasurer.

Sworn to and subscribed before me, this 10 day of Mar., 1922.

_____,
(Official capacity.)

Corporation Income Tax Return.—Continued.

What was the net income for the calendar year 1921 returned to the U. S. Government before taking off any exemption allowed by the Federal law or State income tax	\$	None.
Bad debts charged off in Federal return and not deductible in this return	\$	None.
Total .....	\$	.....
Deduction.		
Dividends not taxable by State, included in Federal return .....		.....
Net income under State law, all of which is taxable .....	\$	.....
Tax at 3 per cent	\$	None.

If Above Form Is Used, It Is Not Necessary to Fill Out This Form.

Gross Income.

1. Gross sales less returns and allowances .....	\$	.....
Plus inventory close of year .....		.....
2. Less cost of raw materials .....	\$	.....
.....	
.....	
.....	
.....	
Wages and labor .....		.....
Total raw materials, wages and labor .....	\$	.....

Plus inventory beginning year.....	\$.....	
Gross income from operation.....		\$32,101.83
3. Gross income from operations other than trading or manufacturing	\$.....	
4. Taxable interest received from all sources.....	.....
5. Rentals .....	.....
6. Royalties .....	.....
7. Income received from partnership.....	.....
8. Total dividends received from foreign corporations, no part of which corporation's income is subject to income tax under the State law. Attach statement showing names of corporations and amount received from each .....	.....
9. Total dividends received from foreign corporations, part of which corporation's income is subject to income tax under the State law. Attach statement showing names of corporations and amount received from each .....	.....
10. Gross income from all other sources subject to tax.....	.....
11. Total income, 3 to 10.....	
12. Total gross income, 1 to 11.....	\$.....	

Corporation Income Tax Return.—Continued.

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Deductions.

1. All the ordinary and necessary expenses paid during the income year in carrying on any trade or business	\$
2. Reasonable compensation of officers .....	.....
3. Rentals or other payments required to be made as a condition of the continued use or possession, for the purpose of the trade or property to which the taxpayer has not taken, or is not taking title, or in which he has no equity .....	.....
4. All interest paid during the income year on indebtedness, except interest on obligations contracted for the purchase of nontaxable securities. Dividends on preferred stock shall not be deducted as interest .....	.....
5. Taxes for the income year, except taxes on income and war profits and excess profits taxes, inheritance taxes, and taxes assessed for local benefit of a kind tending to increase the value of the property assessed .....	.....
6. Dividends from stock in any corporation the income from which shall have been assessed and the tax on such income paid by the corporation under the provisions of this act: Provided, that when only part of the income of any corporation shall have been assessed under this act only a corresponding part of the dividends received therefrom shall be deducted. Attach statement of such dividends .....	.....
7. Losses sustained during the income year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit .....	.....
8. Debts ascertained to be worthless and charged off within the taxable year if the amount has previously been included in gross income as a return made for that year .....	.....

Corporation Income Tax Return.—Continued.

Schedule of Depreciation and Depletion No. 9.

Kind of property.	Cost, or value, Jan. 1, 1921.	Rate.	Depreciation. \$
.....
.....
.....
.....

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Jan. 1, 1921, to Dec. 31.

Balance Sheets.

Assets.	Give dates.	
	1921, beginning of year.	1921, close of year.
Cash on hand and in banks.....	\$2,602.40	\$1,359.75
Accounts receivable	4,397.80	3,748.54
Notes receivable .....	.....	.....
Stocks of other corporations in North Carolina.....	.....	.....
Stocks of other corporations not in North Carolina.....	.....	.....
Bonds of North Carolina.....	.....	.....
U. S. Bonds.....	500.00	.....
Bonds of corporations.....	.....	.....
Inventories.....	.....	.....

[illegible]

Corporation Income Tax Return.—Continued.

39 Reconciliation of Net Income and Analysis of Changes in Surplus.			
Column 1.		Column 2.	
1. Net income from line —, page —	\$	4. Unallowable Deductions	\$
Nontaxable Income:		(a) Income and profits taxes paid to the U. S., its possessions or foreign countries. . . . .	.....
(a) Interest on obligations of the United States and its possessions wholly exempt. . . . .	.....	(b) Life insurance premiums on lives of officers. . . . .	.....
(b) Interest on obligations of State of N. C. . . . .	.....	(c) Income taxes paid to State of North Carolina . . . . .	.....
(c) Dividends on stock of N. C. corporations subject to N. C. income tax . . . . .	.....	(d) Special improvement taxes tending to increase the value of the property assessed . . . . .	.....
(d) Difference between book profit on sale of capital assets and as shown herein. . . . .	.....	(e) Furniture and fixtures, additions, or betterments treated as expense on the books. . . . .	.....
(e) Charges against reserves for bad debts, contingencies, etc. (to be detailed) . . . . .	.....	(f) Renewals and replacements. . . . .	.....
(a) . . . . .	.....	(g) Interest paid to purchase nontaxable securities . . . . .	.....
(b) . . . . .	.....	(h) Additions to reserves: . . . . .	.....
(c) . . . . .	.....		.....

(c)			
3. Surplus and undivided profits as shown by balance sheet at close of preceding taxable year.	.....	Other Unallowable Deductions:	.....
Other Credits to Surplus:	.....	5. Dividends paid during taxable year.	.....
.....	.....	(a) Date paid	.....
.....	.....	Character	.....
.....	.....	Date paid	.....
.....	.....	Character	.....
.....	.....	Date paid	.....
.....	.....	Character	.....
.....	.....	Date paid	.....
.....	.....	Character	.....
.....	.....	Other Debits to Surplus to be Detailed:	.....
.....	.....	(a)	.....
.....	.....	(b)	.....
.....	.....	(c)	.....
Total Column 1.....	\$.....	Total Column 2.....	\$.....
Surplus and undivided profits shown by balance sheet close of year—Column 1 minus Column 2.....	\$.....		

3-744

Filed March 16, 1922.

STATE OF VIRGINIA,

City of Portsmouth, To wit:

Personally appeared before me, a Notary Public in and for the City of Portsmouth, State of Virginia, H. W. MacKenzie, a resident of the aforesaid City and State, who, after being duly sworn, says that:

1. He is now the General Auditor of Seaboard Air Line Railway Company and that he has held such office since March 1st, 1920; that as such officer he has general charge of the books and accounts of said Railway Company, including the ascertainment and reporting of the revenue and expenses of said Railway Company.

2. The annexed document marked Exhibit "A" has been prepared under his supervision and direction from the books and accounts of said Railway Company, that he has examined said document and same is a true and correct copy of the return filed under protest of the said Railway Company with the Commissioner of Revenue of North Carolina pursuant to Section 202 of the Income Tax Act, 1921; the figures given therein are true and correct to the best of his knowledge and belief and the taxable income for the year ending December 31st, 1921, shown by such return is \$437,769.52 and the tax thereon \$13,133.09.

3. The statement hereto attached marked Exhibit "B" was prepared under his supervision and direction; that he has examined said statement and that same correctly shows that the net income of the said Railway Company in North Carolina for the year 1921 when such net income is computed in accordance with the classification of accounts prescribed by the Interstate Commerce Commission; that North Carolina intrastate operating revenues are computed with approximate accuracy; that non-operating income, interstate operating revenue and deductions from gross income are apportioned to the State on an equal operated mileage basis; that operating expenses are allocated to the State in the same ratio that the system's operating expenses bear to the system's operating revenues.

H. W. MACKENZIE

Subscribed and sworn to before me, this 14th day of March, 1922.

[SEAL.]

J. M. DREWRY,
Notary Public

My commission expires April 21st, 1923.

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"EXHIBIT "A."

Form 7.

Public Service Corporation Income Tax Return.

(Railroads.)

For Calendar Year Ending December 31, 1921.

Name, Seaboard Air Line Railway Company.

Business address, Portsmouth, Va.

We, the undersigned, Assistant Comptroller and Assistant Treasurer of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return, including the accompanying schedules and statements, has been examined by him and is, to the best of his knowledge and belief, a true and complete return made in good faith, for the taxable period as stated, pursuant to the Revenue Act for 1921 and the Regulations issued under authority thereof.

(S.)

J. S. HAMILTON,

Assistant Comptroller.

(S.)

T. W. MATHEWS,

Assistant Treasurer.

Sworn to and subscribed before me, this 28th day of February, 1922.

[SEAL.]

J. M. DREWRY,

Notary Public.

(Official capacity.)

My commission expires April 21, 1923.

Net operating income (when business is wholly within the State)	\$
Net operating revenue, including equal mileage proportion within this State of the interstate business when business is in part within and in part without the State)	8,457,328.52
Other income

Total income	\$8,457,328.52
------------------------	----------------

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°Operating expenses (when business is wholly within the State)	\$
°Proportionate average of operating expenses (when business is in part within and in part without the State)	7,308,823.29
°Uncollectible revenue	6,342.31
Taxes paid in this State, other than income and war profits and excess profits taxes	410,043.38
Total deductions	\$7,725,208.98
Operating income, less deductions	\$732,119.31
Plus or minus any credit or debit balance received or paid on account of car hire. And when any railroad is partly within and partly without the State then said net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid	\$294,350.00
Net taxable income	\$437,769.31
Tax @ 3%	\$13,133.00
Main tract mileage (system)	3,563.20
Main track mileage (State)	627.30

42 Railroads and Public-Service Corporations; Basis of Ascertaining Net Income.—The basis of ascertaining the net income of every corporation engaged in the business of operating steam or electric railroad, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the standard classification of accounts of the Interstate Commerce Commission, shall be the "net operating income" of such corporations as shown by their records kept in accordance with that standard classification of accounts, when their business is wholly within this State, and when their business is in part within and in part without the State their net income within this State shall be ascertained by taking their *net income within this State shall be ascertained by taking their* gross "operating revenues" within this State the equal mileage proportion within this State of their interstate business and deducting from their gross "operating revenues" the proportionate average of "operating expenses," or "operating ratio," for their whole business, as shown by the Interstate Commerce Commission standard classification of accounts. From the net operating income thus ascertained shall be deducted "uncollectible revenue," and taxes paid in this State for the income year.

°As per standard Classification of Accounts of Interstate Commerce Commission.

other than income taxes and war profits and excess profits taxes, and the balance shall be deemed to be their net income taxable under this act.

Car Hire Considered.—In determining the taxable income of a corporation engaged in the business of operating a railroad under the preceding section, in the case of a railroad located entirely within this State, the net operating income shall be increased or decreased to the extend of any credit or debit balance received or paid, as the case may be, on account of car hire; and when any railroad is located partly within and partly without this State, then said net operating income shall be increased or decreased to the extend of an equal mileage proportion within this State of any credit or debit balance received or paid, as the case may be, on account of car hire.

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EXHIBIT "B."

Seaboard Air Line Railway Company.

Statement of Income Applicable to State of North Carolina for Year Ended December 31st, 1921, According to the Classification of Accounts Prescribed by the Interstate Commerce Commission.

I. Operating Income:

501. Railway Operating Revenues	\$8,457,328.52
531. Railway Operating Expenses	7,308,823.29
Net Revenues from Railway Operation	1,148,505.23
532. Railway Tax Accruals	410,043.38
533. Uncollectible Railway Revenues	6,342.31
Railway Operating Income	732,119.54

II. Non-operating Income:

504. Rent from Locomotives	6,767.21
505. Rent from Passenger Train Cars	16,900.00
506. Rent from Floating Equipment	18.22
507. Rent from Work Equipment	5,047.23
508. Joint Facility Rent Income	12,664.17
509. Income from Lease of Road	259,525.95
510. Miscellaneous Rent Income	22,387.79
511. Misc. Non-Operating Physical Property	7,685.69
513. Dividend Income	113,350.45
514. Income from Funded Securities	97,257.47
515. Income from Unfunded Securities & Accounts	13,781.90
519. Miscellaneous Income	1,157.22
Non-Operating Income	556,543.30
Gross Income	1,288,662.84

III. Deductions from Gross Income:

536. Hire of Freight Cars—Debits Balance .	277,141.77
537. Rent for Locomotives	19,860.90
538. Rent for Passenger Train Cars	34,108.35
539. Rent for Floating Equipment	2,599.96
540. Rent for Work Equipment	510.31
541. Joint Facility Rents	34,480.56
542. Rent for Leased Roads	10,448.12
543. Miscellaneous Rents	3,194.80
546. Interest on Funded Debts	1,179,252.90
547. Interest on Unfunded Debt	43,823.64
548. Annual allotment of Discount on Bonds	24,494.16
551. Miscellaneous Income Charges	685.25
Total Deductions	1,542,952.06
Net Loss	254,290.31

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Affidavit of E. H. Kemper.

Filed March 18, 1922.

United States District Court, Eastern District of North Carolina.

SEABOARD AIR LINE RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue, et al.

E. H. Kemper, being first duly sworn, deposes and says that he is Comptroller of Southern Railway Company; that Southern Railway Company is a Corporation originally created, organized and existing under the laws of the State of Virginia, owns and operates a line of railroad located partly in Virginia and partly in North Carolina and partly in other states and, in addition, during the year 1921, had, and now has, under lease certain lines of railroad wholly in the State of North Carolina and certain lines of railroad partly in the State of North Carolina as follows:

(a) Owned by North Carolina Railroad, extending from Goldsboro to Charlotte, N. C.: Raleigh, N. C. Entrance to Union Station and Caraleigh Junction, N. C. held under lease bearing date of August 16, 1895, for a term of ninety nine years from January 1, 1866.

(b) Owned by Atlanta & Charlotte Air Line Railway Company, extending from Charlotte, N. C. to Armour, Ga. held under lease dated March 26, 1881, the agreement to remain in force as long as lessee fulfills its obligations thereunder.

(c) Owned by Atlantic & Danville Railway Company, extending from Danville, Va. to West Norfolk, Va.: Shoulders Hill, Va. &

Portsmouth, Va.: Shops, Va. to Portsmouth, Va.; James River Jet., Va. to Claremont Wharf, Va.; Hitchcock Branch Jet., Va. to Hitchcock Mills, Va. and Buffalo Junction, Va. to Buffalo Lithia Springs, Va. held under lease bearing date of August 31, 1899 for a term beginning September 1, 1899 and ending July 1, 1949.

45 (d) Owned by North and South Carolina Railroad Company, extending from N. & S. C. Junction to Mines, N. C. held under lease bearing date August 31, 1899.

(c) Owned by Southern Railway—Carolina Division, extending from Kingville, S. C. to Marion, N. C.

Sumter Junction, S. C. to Sumter, S. C.

Blacksburg, S. C. to Gaffney, S. C.

Branchville, S. C. to Columbia, S. C.

Biltmore, N. C. to Hayne, S. C.

Hendersonville, N. C. to Lake Toxaway, N. C.

Spartanburg, S. C. to Alston, S. C.

Charleston, S. C. to Savannah River near Augusta Ga.

Burton Branch, S. C.

Cayce, S. C. to Hardeeville, S. C.

Perry, S. C. to Sievern, S. C.

Held under lease bearing date June 30, 1920, for a term of 999 years beginning July 1, 1902.

(f) Owned by North Carolina Midland Railroad extending from Mooresville Junction, N. C. to Winston-Salem, N. C. bearing date of February 5, 1916 and extended for a term to run and continue after December 31, 1920 until the expiration of 30 days in writing by either party to the other of the election to terminate such lease.

E. H. KEMPER.

Sworn and subscribed to before me this 15 day of March 1922.

[Notarial Seal.]

J. C. NAUGHTEN,
Notary Public.

Answer.

Filed Mar. 30, 1922.

In the District Court of the United States for the Eastern District
North Carolina.

In Equity.

No. —.

SEABOARD AIR LINE RAILWAY COMPANY, Complainant,

v.

A. D. WATTS, Commissioner of Revenue of North Carolina, Benjamin R. Lacy, State Treasurer of North Carolina; Baxter Durham, State Auditor of North Carolina, and James S. Manning, Attorney-General of North Carolina, Defendants.

Answer.

To the Honorable H. G. Connor, Judge of the District Court of the
United States for the Eastern District of North Carolina:

The defendants above named, answering the bill herein, respectfully show the Court that:

1. Article I of the complaint is admitted.

2. Article II of the complaint is admitted.

3. It is admitted that the amount in controversy herein, exclusive of interest and cost, exceeds the sum of \$3,000. But defendants expressly deny that complainant has any equity to enjoin defendants from collecting the income tax attacked by said complainant; that said railroad company will be deprived of any privilege guaranteed and secured to it by the Constitution of the United States and the Fourteenth Amendment thereof; that it will be deprived of its property without due process of law; that it will be denied the equal protection of the law in contravention of the Constitution of the United States and the Fourteenth Amendment thereof; and that the taxes sought to be imposed by virtue and under the authority of the North Carolina statute constitute a direct burden upon interstate commerce, in violation of the commerce clause of the Federal Constitution.

4. Article IV of the bill is admitted.

5. Article V of the bill is admitted.

6. Article VI of the bill is admitted.

7. Article VII of the bill is admitted.

8. Article VIII of the bill is admitted.

9. Article IX of the bill is admitted.

10. Article X of the bill is admitted.

11. Article XI of the bill is admitted.

12. Article XII of the bill is denied. Further answering said article, defendants respectfully show the Court:

(a) The income-tax provision of the Constitution of the State of North Carolina, quoted in Article IV of the bill, authorizes the Legislature to determine what shall be the net income to be taxed thereunder, and expressly prohibits the allowing of any deduction for living expenses. The statute enacted by the General Assembly of 1921 in pursuance of such constitutional authority (Chapters 34 and 35 of the Public Laws of 1921), classifies income-tax payers as follows, providing for each class a different method for ascertaining taxable incomes: first, resident individuals; second, nonresident individuals, Section 200; third, resident corporations; fourth, nonresident corporations, Section 201; fifth, railroads and other public-service corporations having their lines wholly within the State; and sixth, railroads and other public-service corporations having their lines partly within the State and partly without; and the defendants are advised, and so aver, that such classification does not in any way offend against any provision of the State or Federal Constitution.

48 No one of these classes is allowed the same deduction or exemption as those allowed to the other classes, and in each case the distinctions made are made on account of an inherent difference between the classes themselves.

(b) The statute itself (Section 202) provides the method by which the net income of railroads is to be ascertained. It declares that, as to such railroads operating wholly in the State, the net income shall be "the net operating income" as shown by their records, kept in accordance with the standard classification of accounts of the Interstate Commerce Commission. As to railroads, when their business is part within and part without the State, it declares their net income within the State shall be ascertained by taking their gross "operating revenues" within this State, including in their gross "operating revenues" within this State the equal mileage proportion within this State of their interstate business, and deducting from their gross "operating revenues" the proportionate average of "operating expenses," or "operating ratio," for their whole business, as shown by the Interstate Commerce Commission standard classification of accounts. From the sum so found, they are allowed to deduct "uncollectible revenue" and taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes, etc., and the balance shall be deemed to be their net income taxable under this act. The method thus provided by the General Assembly for ascertaining the net income of such railroads, defendants are advised and aver, is both legally and constitution-

ally a proper one to apply to them, and does not offend against the interstate commerce clause of the Federal Constitution.

(c) That deductions and exemptions are allowed individuals which are not allowed ordinary corporations or railroads, and that deductions are allowed ordinary corporations which are not allowed railroads, in specific terms, arises from the necessity to classify income-tax payers, so as to arrive at their net income, and that necessity arises from differences inherent in the various businesses

49 thus classified. Without such classification, defendants are advised and believe, it would be impossible to levy a fair and just income tax. Defendants are advised and believe that, in applying the method provided in the act, many deductions are necessarily allowed, besides those specifically set out in Section 202, "uncollectible revenue," and taxes paid in this State for the income year etc., i. e., wages of employees, salaries of officers, if reasonable amount, for services actually rendered in producing such income, and others too numerous to incorporate in this answer. A list of them is hereto attached, marked "Exhibit A," and is asked to be taken a part of this answer.

It is admitted that complainant has copied correctly Section 306 of the Revenue Act in subsection (c) of Article XII of its bill, but it is expressly denied that there has been any discrimination against railroads and in favor of ordinary business corporations.

13. Article XIII of the bill is not true as stated, and so is denied.

14. Article XIV of the bill is not true as stated, and so is denied. It is admitted that interest paid during the tax year on outstanding bonded indebtedness is not one of the deductions allowed to railroads whereas it is allowed to individuals and business corporations, but many other deductions are allowed to railroads which are not allowed to either individuals or business corporations. See Exhibit A. Defendants are informed and believe, and so aver, that the method of financing railroads is so wholly different from that of other corporations that they are necessarily in a class to themselves with other public-service corporations, and that a refusal, under such circumstances, to permit a deduction for interest on their bonded indebtedness is justified and is not a discrimination against them. The statute (Section 306, sub-section 3) expressly prohibits the deduction of dividends on preferred stock to business corporations.

50 15. Article XV of the bill is not true as stated, and so is denied. It is expressly averred that the Income Tax Act of 1921 does operate equally and uniformly upon all taxpayers in similar circumstances, and that the variations in its operation are caused by the differences in the character of the objects upon which it operates, and it does in effect classify these various objects to meet the differences, and so the complainant is not denied the equal protection of the law and is not deprived of its property without due process of law in contravention of the Fourteenth Amendment to the Constitution of the United States.

16. Article XVI of the bill is not true as stated, and so is denied. The Constitution of North Carolina, no less than the Federal Constitution, permits classification in a proper case, and defendants aver that the classification in the income-tax law is both just and necessary to comply with the Constitution of the State that such taxes should be uniform.

17. Article XVII of the bill is not true as stated, and so is denied.

18. Article XVIII of the bill is not true as stated, and so is denied. The defendants affirm that the Income Tax Act of 1921 does apply to railroads and public-service corporations deriving their income from sources other than the operation of their property.

19. Article XIX of the bill is not true as stated, and so is denied. Section 3, Article V of the State Constitution, expressly authorizes the General Assembly, at its discretion to tax incomes. If it does determine to tax incomes, it may not in any case exceed 6 per cent; it may not in any case decrease the minimum amount of exemption allowed to individuals. It may allow other deductions, not including living expenses, so that net incomes are taxed. With these limitations, then, the Legislature has authority to determine what is net income.

20. Article XX of the bill is not true as stated, and so is denied. The General Assembly has declared what shall constitute net incomes in the case of railroads, and, as appears by Exhibit A, a very large number of deductions are allowed from gross income in determining what is net income. In no sense, then, defendants aver, can a tax on such income be a tax upon a gross income or a burden on interstate commerce.

21. Article XXI of the bill is not true as stated, and so is denied. Section 202, far from prescribing a system of accounting for an interstate railroad, adopts the system partially already prescribed by Interstate Commerce Commission as a means of arriving at the net income of the complainant earned within the State of North Carolina.

22. Article XXII of the bill is not true as stated, and so is denied. It is true that the General Assembly of North Carolina, under authority conferred upon it by the amendments to the State Constitution, adopted at the general election of 1920, and which became effective January 7, 1921, declined to levy any State ad valorem tax, but left such tax wholly to the counties and other subordinate governmental agencies of the State. It is true that it levied a franchise tax of one-tenth of one per cent upon the value of railroad property in the State for the benefit of the State. It is true, also, that it levied an income tax of 3 per cent upon the net incomes of railroads and all other corporations, but defendants deny that any one or all of these methods of taxation for State purposes constitutes such taxes a burden upon interstate commerce, or violates in any sense the Constitution of the United States.

23. Article XXIII of the bill is not true as stated, and so is denied. The amendments to the State Constitution, commonly called the taxation amendments, were adopted at the general election of 1920, and became effective January 7, 1921. The defendants are advised and believe that such amendments authorized the General Assembly of the State to adopt the general scheme of taxation, which it commenced to put into effect at the Extra Session of August 1920, and put in full force in the Revenue Act of 1921; that the general scheme of taxation is wholly within the authority of the State, and can only be attacked when the legislation enacted in pursuance thereof, or the administration of such taxing laws, destroys some constitutional right of the complainant; that the refusal of the State to levy an ad valorem tax upon the property of the defendant, while it permits subordinate governmental agencies to levy this tax under the rules, regulations and restrictions contained in the State Constitution, can in no sense, as defendants aver and believe, impair any constitutional right of the complainant; that the State, as defendants are advised and believe, may constitutionally levy a license or franchise tax upon complainant for the privilege of performing its functions in the State; an income tax upon income earned in the State, and also an ad valorem tax upon its property for the benefit of the State; that its refusal to levy the latter cannot, as defendants aver, affect the constitutionality of the levy of the franchise and income tax. Defendants particularly deny that there has been any exemption of any class of property from the general burdens of taxation, as alleged in Article XXIII of the bill, and defendants aver that the scheme of taxation of the shares in incorporated companies in the hands of the shareholders, as provided in the Revenue and Machinery Acts of 1921, has been in effect in the State for more than twenty years; said shares being taxed at the principal office of the corporation itself.

24. Article XXIV of the bill is not true as stated, and so is denied. Particularly it is denied that the Revenue Act of 1921 is in any particular retroactive or retrospective within the meaning of Section 1 of Article I of the State Constitution.

25. It is true that the Commissioner of Revenue has sent to complainant the form for return of income tax for the calendar year ending December 31, 1921, attached to the bill. It is admitted that he will proceed to collect, in accordance with the machinery of the law, a proper income tax from complainant, but it is expressly denied that any greater income tax will be collected from complainant than that collected from all other public-service corporations under the same circumstances and conditions; and it is averred that the deductions claimed by complainant are not such as the law allows, and that if complainant pays such taxes under protest it has an adequate remedy at law under Section 600 of the C. S. of 1919.

26. Defendants expressly deny that the penalties provided for failure to pay such income tax in Section 600 of the Revenue Act

excessive, unreasonable, oppressive and inequitable. Those penalties are imposed for wilful or fraudulent failure to comply with the provisions of the act, and so would not be a denial of due process of law to the defendant.

Wherefore, having fully answered all the allegations of the bill herein, the defendants pray judgment:

1. That the bill be dismissed.
2. For cost of this action.
3. For such other and further relief as to the Court may seem just.

JAMES S. MANNING,
Attorney-General of North Carolina,
FRANK NASH,
Assistant Attorney-General of North Carolina,
Solicitors for Defendants.

GEO. H. BROWN,
WM. P. BYNUM,
LOCKE CRAIG,
THOS. D. WARREN,
S. S. ALDERMAN,
Of Counsel.

A. D. Watts, one of the defendants, being duly sworn, says that he is State Commissioner of Revenue; that he has read the foregoing answer and knows the contents thereof; that the same is true, of his own knowledge, except as to matters therein stated on information and belief, and as to those matters he believes it to be true.

A. D. WATTS.

Sworn and subscribed to before me, this March 28, 1922.

EDWARD SEAWELL,
Deputy Clerk Supreme Court.

EXHIBIT A.

Superintendence; roadway maintenance; underground power lines; tunnels and subways; bridges, trestles, and culverts; ties; rails; track material; ballast; track laying and surfacing; right of way fences; crossings and signs; station and office buildings; roadway buildings; water stations; fuel stations; shops and engine-houses; main elevators; storage warehouses; wharves and docks; telegraph and telephone lines; signals and interlockers; power plant buildings; power transmission systems; power distribution systems; power line poles and fixtures; underground conduits; miscellaneous structures; paving; roadway machines; small tools and supplies; removing snow, ice, and sand; assessments for public improvements; injuries to persons; insurance; stationery and printing; other expenses; superintendence; shop machinery; power plant machinery; steam locomotive

tives—repairs; steam locomotives—depreciation; steam locomotives—retirements; freight-train cars—repairs; freight-train cars—depreciation; freight cars—retirements; passenger-train cars—repairs; passenger-train cars—depreciation; passenger-train cars—retirements; motor equipment of cars—repairs; motor equipment of cars—depreciation; floating equipment—repairs; floating equipment—depreciation; work equipment—repairs; work equipment—depreciation; work equipment—retirements; miscellaneous equipment—repairs; miscellaneous equipment—depreciation; injuries to persons; insurance; stationery and printing; other expenses, maintaining joint equipment at terminals; maintaining joint equipment at terminals—Cr.; superintendence; outside agencies; advertising; trade associations; industrial and immigration bureaus; insurance; stationery and printing; other expenses.

Superintendence; dispatching trains; station employees; weighing, inspection, and demurrage bureau; station supplies and expenses; yardmasters and yard clerks; yard conductors and brakemen; yard switch and signal tenders; yard engineers; fuel for yard locomotives; water for yard locomotives; lubricants for yard locomotives; other supplies for yard locomotives; engine-house expenses—yard; yard supplies and expenses; train engineers; train motormen; fuel for train locomotives; water for train locomotives; lubricants for train locomotives; other supplies for train locomotives; enginehouse expenses—train; trainmen; train supplies and expenses; operating sleeping cars; signal and interlocker operation; crossing protection; drawbridge operation; telegraph and telephone operation; operating floating equipment; stationery and printing; other expenses; insurance; clearing wrecks; damage to property; damage to livestock on right of way; loss and damage—freight loss and damage—baggage; injuries to persons; operating joint yards and terminals—Dr.; operating joint yards and terminals—Cr.; operating joint tracks and facilities—Dr.; operating joint tracks and facilities—Cr.; dining and buffet service; hotels and restaurants; producing power sold; salaries and expenses of general officers; salaries and expenses of clerks and attendants; general office supplies and expenses; law expenses; insurance; pensions; stationery and printing; valuation expenses; other expenses; general joint facilities—Dr.; general joint facilities—Cr.; transportation for investment—Cr.

Grand total railway operating expenses, \$37,465,817.12.

66 *Extract from the Minutes of the Court, April 15, 1922.*

In the District Court of the United States for the Eastern District
of North Carolina.

In Equity.

No. 447.

SEABOARD AIR LINE RAILWAY COMPANY

VS.

A. D. WATTS et al.

Present: The Honorable Henry G. Connor, Judge of the District
Court for the Eastern District of North Carolina.

Order.

"It is ordered that this cause be set down for final hearing on its
merits on Monday, June 13, 1922, Counsel for Plaintiff and De-
fendants being in open Court and assenting thereto; application for
Interlocutory Injunction being waived by Counsel for Plaintiff."

57 *Affidavit of H. W. Mackenzie.*

Filed May 19, 1922.

In the District Court of the United States for the Eastern District of
North Carolina.

Equity, #447.

SEABOARD AIR LINE RAILWAY COMPANY

VS.

A. D. WATTS, Commissioner of Revenue, et al.

STATE OF VIRGINIA,
City of Portsmouth:

Personally appeared before me, a Notary Public in and for the
City of Portsmouth, State of Virginia, H. W. Mackenzie, a resident
of the aforesaid City and State, who after being duly sworn says:

1. That he is the General Auditor of Seaboard Air Line Railway
Company and that he has held such office since March 1st, 1920;
that as such officer he has general charge of the books and accounts
of said Railway Company, including the ascertainment and report-
ing of the revenues and expenses of said Railway Company; that he
an expert accountant and is thoroughly familiar with accounting.

2. That he attaches hereto as Exhibit A the Classification of Income, Profit and Loss, and General Balance Sheet Accounts for Steam Roads Prescribed by the Interstate Commerce Commission in accordance with Section 20 of the Act to Regulate Commerce, which classification is now in effect and has been in effect since July 1st, 1914

58 3. That he also attaches as Exhibit B Classification of Operating Revenues and Operating Expenses of Steam Roads Prescribed by the Interstate Commerce Commission in accordance with Section 20 of the Act to Regulate Commerce, which classification was in effect and has been in effect since July 1st, 1914

4. That he is thoroughly familiar with the aforementioned classification of accounts of the Interstate Commerce Commission and has been so familiar for many years and that there is no account in the said classification of accounts of the Interstate Commerce Commission designated as Net Operating Income: there is, however, an account designated as Railway Operating Income.

5. That *is* Net Operating Income as employed in Section 209 of the North Carolina Income Tax Act of 1921 is to be construed as the income defined as Railway Operating Income in Section 1 of the Federal Control Act, Section 15-A of the Interstate Commerce Act and Section 209 of the Transportation Act 1920, then the basis of ascertaining such Net Operating Income of a railroad whose business is entirely within the State of North Carolina differs under the said North Carolina Income Tax Act from the method prescribed in the said Act for ascertaining such income for railroad companies whose business is partly within and partly without the State of North Carolina for the reason that those railroads whose business is partly within and partly without the State are not allowed deductions from the gross operating income of the following items, which items, however, are allowed railroads whose business is wholly within the State of North Carolina:

Locomotion hire,
Working equipment hire,
Floating equipment hire and
Joint Facility rents.

59 All of the foregoing accounts are fully set forth and described in the classification of accounts attached hereto. Therefore, railroads and other public service corporations described in Section 2-2 of the said North Carolina Income Tax Act, whose business is wholly within the State of North Carolina, are necessarily entitled under the said Act to the aforementioned deductions and consequently, the Income Tax assessed against them is upon a lesser proportion of their gross income than is the case with similar companies whose business is partly within and partly without the State of North Carolina, and to the extent that these deductions are allowed a corporation whose business is entirely within the State and denied a similar corporation whose business is partly within and partly without the State, there is an actual discrimination against

corporation whose business is partly within and partly without the State.

6. That under all rules of accounting net income of a corporation is, as a matter of fact, that amount received by such corporation after the deduction from its gross income of all of the expenses of operating its property and that such expenses necessarily include such items as rentals paid for property used in earning said income and interest paid on indebtedness on said property utilized in earning such income.

H. W. MACKENZIE.

Subscribed and sworn to before me this 17th day of May 1922.

J. M. DREWRY,
Notary Public.

My commission expires April 21st, 1923.

I hereby certify that this is a case in which by the laws of Virginia no tax is required upon the affiant.

[Notarial Seal.]

J. M. DREWRY,
Notary Public.

60

Affidavit of W. L. Stanley.

Filed May 20, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

Equity. No. 447.

SEABOARD AIR LINE RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue, et al.

STATE OF GEORGIA,
County of Fulton:

This day personally appeared before me, C. L. Chappell, a Notary Public in and for the State and County aforesaid, W. L. Stanley, who after being duly sworn, says:

1. That he is General Attorney of the Seaboard Air Line Railway Company, the Complainant in this suit; that he is in general charge of the taxation matters of the said Railway Company and that his duties include the making of returns to enable the authorities of the several states traversed by the said Railway Company to assess the value of the property of the said Railway Company for taxing purposes, of which work he has been in charge for approximately sixteen years.

4-744

2. That under an Act of the General Assembly of North Carolina, ratified the eleventh day of March 1919, and commonly known as "The Revaluation Act," all property including that of railroads was required to be assessed as of the first day of May, 1919, at its true value in money; that in conformity with and in pursuance of this act, the State Tax Commission fixed the value of the property of the Seaboard Air Line Railway Company in the State of North Carolina as of May 1st, 1919, at Thirty-four Million, Seven Hundred Sixty-eight Thousand Four Hundred and Forty Dollars (\$34,768,440.00); That said assessment continued in effect for the year 1920, and that the Commissioner of Revenue of North Carolina has fixed the value of said property as of May 1st, 1921, at the foregoing figure, to-wit: Thirty-four Million Seven Hundred Sixty-eight Thousand Four Hundred and Forty Dollars (\$34,768,440.00).

3. That under Section 82 (61½) of a North Carolina Act entitled "An Act to Raise Revenue," approved March 8th, 1921, the Commissioner of Revenue of North Carolina assessed against the Seaboard Air Line Railway Company for the year 1921 a tax of Thirty-four Thousand Seven Hundred Sixty-eight Dollars and Forty-four cents (34,768.44), said amount being one-tenth of one per cent of the valuation fixed by the said Commissioner as set forth in the preceding paragraph hereof.

4. That the various counties, cities and towns, and other local subdivisions of the State of North Carolina traversed by the line of the said Railway Company have assessed against it for the year 1921 taxes upon the property of the said Railway Company aggregating Four Hundred Twenty-nine Thousand Three Hundred Forty-two Dollars and Eighty-nine Cents (\$429,342.89).

W. L. STANLEY.

Subscribed and sworn to before me in Atlanta, Georgia, this 18th day of May, 1922.

[Notarial Seal.]

C. L. CHAPPELL,
Notary Public, State at Large, Georgia.

My commission expires Nov. 28, 1923.

62

Affidavit of Nathan O'Berry.

Filed May 23, 1922.

In the District Court of the United States for the Eastern District of
North Carolina.

In Equity.

No. 417.

SEABOARD AIR LINE RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.

Nathan O'Berry, being first duly sworn, deposes and says:

1. That he is a citizen and resident of the State of North Carolina and County of Wayne, that he is President of Enterprise-Whiteville Lumber Company.

2. That said company is an industrial corporation engaged in operating lumber mills located respectively at Whiteville and Mt. Olive, North Carolina.

3. That said company, as a part of its business constructed a line of railroad extending from Whiteville, N. C., to Butlers, N. C., a distance of about 27 miles, and also constructed a line of railroad extending from Mt. Olive, N. C., to New Camp, N. C., a distance of about 18 miles.

4. That said railroads were established and maintained solely by the owner of the lands upon which the said roads were constructed and the principal business of said railroad is the transportation of logs, lumber and other articles of the owners of said railroad.

5. Acting under the provisions of section 3413 of the Consolidated Statutes of North Carolina, the said corporation applied to the Corporation Commission of North Carolina for authority to said corporation to transport between the termini of said two lines of railroad, commodities other than that owned by the said lumber company, and for authority to charge therefor reasonable rates to be approved by said corporation.

63 6. The Corporation Commission, under the powers vested in it under said section 3414 of the Consolidated Statutes of North Carolina, duly authorized the said corporation to act as a common carrier between the termini of its said two lines of railroad and established a scale of rates which said corporation might charge for the transportation of the kind and character of commodities which it was authorized to transport for others for such services.

7. That the said corporation does not have any tariff filed with Interstate Commerce Commission, and is not authorized to and does not engage in the transportation of freight or passengers in interstate commerce, or between any points other than those on its own line. That the said corporation, during the year 1921, paid interest on account of money borrowed, that the said corporation in making its income tax returns to the Commissioner of Revenue of the State of North Carolina, deducted from its gross income the interest so paid in order to arrive at its net income, this deduction being made in addition to the other deductions allowed under section 306, schedule D of the Revenue Act of North Carolina.

8. This affiant is informed and believes that it was entirely proper under the laws of North Carolina for said corporation to deduct the interest paid during the year 1921 from its gross income, together with the other deductions allowed in section 306 of schedule D Revenue Act of North Carolina from its gross income in order to ascertain the net income subject to tax.

NATHAN O'BERRY.

Sworn and subscribed to before me this 17th day of May, 1922.

[SEAL.]

C. W. BRINKLEY,
Notary Public.

My commission expires January 24th, 1924.

64

Affidavit of A. R. Turnbull.

Filed May 23, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 447.

SEABOARD AIR LINE RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.

A. R. Turnbull, being first duly sworn, deposes and says:

1. That he is President of the Rowland Lumber Company.

2. Rowland Lumber Company is a corporation duly organized and existing under the laws of the State of North Carolina, the principal business of the said company is the manufacture of lumber.

3. That it operates a large mill in North Carolina, located at New Bern, and has under lease a line of railroad extending from Clarks Junction, a point on the Atlantic & North Carolina Railroad, west-

wardly to and beyond New River and thence to Chinquapin, and a few miles beyond, where it connects with a line of railroad owned by Rowland Lumber Company, which extends to Kenansville, where it connects with a line of railroad owned by Atlantic & Carolina Railroad Company.

4. The principal business of the said railroad running from Kenansville to Clarks Junction, through Chinquapin is the transportation of logs and lumber for the owner of such railroad.

5. The Corporation Commission of North Carolina, acting under the power vested in it by section 3413 Consolidated Statutes of North Carolina, has granted to Rowland Lumber Company authority to transport commodities of certain kinds and character other than owned by the said Rowland Lumber Company over that part of the said line of railroad between Kenansville and Chinquapin and to charge therefor a scale of rates fixed and established by the Corporation Commission of North Carolina.

65 6. Rowland Lumber Company does transport for others than itself commodities of the kind and character authorized by said authority to be transported and charges therefor the scale of rates authorized by the Corporation Commission.

7. That the Rowland Lumber Company is not engaged in interstate commerce and has never filed any tariffs with the Interstate Commerce Commission, and has not been authorized to engage in interstate commerce, and is prohibited under the law from so doing until it has filed tariffs with the Interstate Commerce Commission as required by the Interstate Commerce Act.

8. That during the calendar year 1921, which is the income tax year for 1921 in the State of North Carolina, Rowland Lumber Company paid rent for the line of railroad operated by it as aforesaid and also paid other rents for properties used in its said business and to which it had no equity except its leasehold, and also paid sums as interest for money borrowed and used in its business.

9. Affiant is informed and believes that Rowland Lumber Company is, under the income tax law of North Carolina, schedule D, of Chapter 34, entitled to deduct the amounts so paid as interest and rent, together with other deductions allowed by said schedule from its gross income, in order to arrive at its net income subject to tax under the said tax laws of North Carolina.

10. That the said railroad is of standard gauge and can and does receive cars from other lines of railroad, which it transports to destination on its own line.

A. R. TURNBULL.

Sworn and subscribed to before me this 20th day of May, 1922.

[SEAL.]

J. B. DEY, JR.,

Notary Public.

Com. expires Sept. 18, 1923.

Affidavit of C. D. Bradham.

Filed May 25, 1922.

In the District Court of the United States for the Eastern District
of North Carolina.

In Equity.

No. 447.

SEABOARD AIR LINE RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue, et al.

C. D. Bradham, being first duly sworn, deposes and says, that he is President of the Atlantic & North Carolina Railroad Company; that prior to the year 1921, the Atlantic & North Carolina Railroad Company leased to the Howland Improvement Company its line of railroad, extending from Morehead City to Goldsboro, North Carolina.

That the Norfolk Southern Railroad Company is the successor in title to the said leasehold interest granted by said lease and during the year 1921 was in possession of said line of railroad under said lease and used the same exclusively and conducted and carried on the business of a common carrier over said line of railroad.

That during the said year 1921, Norfolk Southern Railroad Company paid the Atlantic & North Carolina Railroad Company the amount of rent required by said lease to be paid for the continued use of said property in the trade or business of Norfolk Southern Railroad Company; that the payment of the said rent was a condition precedent to the continued use of the said property by the Norfolk Southern Railroad Company in its business.

That the Norfolk Southern Railroad Company has not taken title to the said property, was not taking title thereto, and has no equity in the property owned by the Atlantic & North Carolina Railroad Company.

67 That under the terms of the said lease, Norfolk Southern Railroad Company, as Lessee, is required to pay any Income Tax levied upon the income of the Atlantic & North Carolina Railroad Company derived from or under said lease.

That the amount of money received from Norfolk Southern Railroad Company as rent for the use of said property is substantially the entire income of the Atlantic & North Carolina Railroad Company.

C. D. BRADHAM.

Subscribed and sworn to before me this 17th day of May, 1922.
[SEAL.]

H. J. CARPENTER,
Notary Public.

My commission expires on the 7th day of Oct. 1922.

68

Affidavit of O. S. Thompson.

Filed June 5, 1922.

In the District Court of the United States for the Eastern District
of North Carolina.

In Equity.

No. 447.

SEABOARD AIR LINE RAILWAY COMPANY, Plaintiffs,

vs.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, et als.,
Defendants.

Railroad Income Tax Suits.

Affidavit of O. S. Thompson.

O. S. Thompson being duly sworn, deposes and says:

Since 1906 affiant has been connected with the Corporation Commission of North Carolina, and with the State Department of Revenue since its creation in 1921. The Corporation Commission, in addition to its duties as such, was by statute created the State Tax Commission with the duties of administering the tax laws of the State. Affiant's position with the said State Tax Commission was that of Tax Clerk, and as such his duties were the general supervision of the details of the administration of the tax laws of the State. While Tax Clerk of the State Tax Commission affiant had extensive experience with the Standard Classification of Accounts of the Interstate Commerce Commission in connection with preparing the reports of the Corporation Commission based in part on the said Standard Classification.

Affiant is now Deputy Commissioner of Revenue of North Carolina and acting Chief Clerk of the State Department of Revenue and his duties as such are similar to those formerly performed by him as Tax Clerk of said State Tax Commission. Prior to 1906 affiant served as an employee of the Southern Railway Company as clerk handling taxation matters.

69 In his capacity as Deputy Commissioner of Revenue and acting Chief Clerk of the State Department of Revenue, the affiant is familiar with the requirements of that department as to returns for taxation by taxpayers, with the forms of such returns, and is custodian of the records of the State Department of Revenue. Affiant is familiar with the administration of the tax laws of the State by the State Department.

The State Department of Revenue has only one blank for returns for income tax which is sent out to and used by all railroad

corporations engaged in the operation of railroads. This is known as Form 7, and is attached to this affidavit, marked Exhibit A. This form is required by the State Department of Revenue to be filled out by all railroads doing business in the State of North Carolina, whether operating partly within or partly without the State, whether operating wholly within the State but as common carriers with interstate railroads, or whether doing wholly intrastate business. This form 7 requires a report by all such railroad corporations of their net income as defined by the Income Tax Act of 1921, under the provisions of section 202 of that Act, and based upon and according to the Standard Classification of Accounts of the Interstate Commerce Commission.

The State Department of Revenue requires all such railroad corporations to make return for income taxation upon this form and ascertain the net income of such railroads for taxation without discrimination according to the provisions of the said section 202.

Affiant has read the affidavits of Nathan O'Berry, President of the Enterprise-Whiteville Lumber Company, and of Mr. A. R. Turnbull, President of the Rowland Lumber Company, filed in their suits by the Norfolk Southern Railroad Company. It is true that these lumber companies and other similar companies are not classed as railroads by the State Department of Revenue, are not treated as railroads for income tax purposes or for any other purposes

whatsoever, and are not required to make returns for income tax according to the Standard Classification of Accounts and upon Form 7, but are required to and do make return for income

tax on Form 3, which is the form required by the Department for corporations in general other than the railroads and other public service corporations taxed according to section 202. In fact, these lumber companies and other similar companies are not railroads and are not public service corporations. As is stated in the said affidavit by the presidents, their principal business is the lumber business, only such transportation as they carry on is principally the transportation of their own property as incident to the lumber business. Under section 3413, Consolidated Statutes, the Corporation Commission has the power to grant to such companies authority to transport certain commodities other than their own property, subject to the supervision of the Commission, but the affiant is informed and believes that the purpose of such provision is simply to allow such companies to accommodate immediate communities in which they operate; that when such authority is granted to and exercised by such companies they do not engage in the business of transportation as common carriers for others for profit, but only as the purely incidental service of accommodation; that in any such case the transportation of property of others by such a corporation is wholly negligible in amount and purely incidental to the principal business of the corporation, which is the lumber business.

Affiant states, therefore, as a matter of his own knowledge, that the Income Tax Act of 1921, as administered by the State Department of Revenue, applies exactly in the same way and without discrimination whatsoever to all railroad corporations doing business

in the State engaged in railroad operation, whether foreign or domestic, whether operating partly within and partly without the State, or wholly within the State. All are required to make return for income tax according to the Standard Classification of Accounts and under section 202, and exactly the same deductions are allowed to all, without discrimination.

71 Not only is the entire class of railroads subjected to income taxation under the provisions of section 202 with ascertainment of net income upon the basis of the Standard Classification of Accounts, but the same is true as to the broader class of all strictly public service corporations, not including such lumber companies as are above referred to and which the affiant is informed and believes are not public service corporations at all.

The State Department of Revenue has one form for income tax return for all public service corporations other than railroads, Form 8, a copy of which is attached hereto and marked Exhibit B, and which form is substantially identical with Form 7 upon which railroads are required to make return. The Department of Revenue requires, therefore, not only of railroads, but of all other public service corporations, that they file returns for income tax upon the basis of the Standard Classification of Accounts, under the provisions of section 202.

Affiant has read the affidavit of Mr. J. H. Bridgers, President of the Henderson Water Company, in which Mr. Bridgers states that the Henderson Water Company is not required to and does not keep its records according to the Standard Classification of Accounting, and that it did not make return for income taxation according to the said classification under the provisions of section 202. Affiant states that the returns for income taxation in the office of the Department of Revenue for the year ending December 31st, 1921, have not yet been audited and checked for correctness. If what Mr. Bridgers says with reference to the return made by the Company is true, his company will be required to amend its return and to file a return on Form 8 according to the said Standard Classification and under the provisions of section 202. As the Department of Revenue interprets the Income Tax Act, the Henderson Water Company, as well as all other public service corporations, are required to make return for income tax in accordance with the accounting system of the Standard Classification. The auditing of income tax returns for 72 the said year is in progress at this time, but has not been completed, and, with reference to railroads and other public service corporations, has been held over pending decision in these suits as to the validity of the income tax as to such corporations, in view of the plaintiffs' attack upon the income tax law as applied to them.

O. S. THOMPSON,

Affiant.

Subscribed and sworn before me this 5 day of June, 1922.

[SEAL.]

W. H. PITTMAN,

Notary Public.

My commission expires July 29, 1922.

Affidavit of A. J. Maxwell.

Filed June 5, 1922.

In the District Court of the United States for the Eastern District
North Carolina.

In Equity.

No. 447.

SEABOARD AIR LINE RAILWAY COMPANY, Plaintiffs,

vs.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, et al
Defendants.

Railroad Income Tax Suits.

Affidavit of A. J. Maxwell.

A. J. Maxwell, being first duly sworn, deposes and says:

Affiant is a member of the State Corporation Commission of North Carolina and has been such since 1910, during which time the said commission was, until 1921, also the State Tax Commission with the duties and functions with reference to administering the tax laws of the State imposed upon the newly created State Department of Revenue by the statute of 1921. In such position the affiant has been directly connected in an official capacity with the administration of the tax laws of the State until the creation of the State Department of Revenue to replace the State Tax Commission as such. In such capacity the affiant was in constant consultation with the finance committees of the General Assembly at the time of the drafting of the Income Tax Act of 1921. In such capacity the affiant has had extensive experience familiarizing him with the Standard Classification of Accounts of the Interstate Commerce Commission, has made a special and comparative study of the tax systems of other states and of the subject of taxation.

When the enactment of the Income Tax Act of 1921 was under consideration in the finance committees of the General Assembly, the railroads were heard on the matter and they made the same objection to the provisions of Section 202 that they are now making in the suits. They argued that the application of those provisions

74 to them would not lead to an ascertainment of their net income because certain items, notably interest on bonded indebtedness and rentals paid for leased properties, were not included in the operating expenses in the said Standard Classification, whereas to individuals and to corporations other than public service corporations deductions were allowed under general terms of the act, which the railroads alleged to be analogous to such interest and rentals.

The legislative committees considered these objections fully and carefully. In enacting the Act in the terms finally adopted, the General Assembly considered certain well-known facts with reference to the method in which railroad corporations are financed. It is a general rule that railroads are financed almost entirely by bond issues, their stock being issued largely incidentally and sometimes even distributed as bonus with the bonds. The rule is that the capital expenses are procured by bond issues. This being the case, interest paid on the bonds is properly considered not as a current operating or business expense, but as a capital expense. The legislature considered that "net income" as generally understood and as judicially defined means the business revenues less all those expenses incurred in the earning of such revenues, but not deducting any expense on account of or to provide for capital or permanent investment in the business. It was manifest, therefore, that if interest on bonds should be allowed as a deduction in arriving at net income of railroads, this would be the allowing of a capital expense, not an operating or business expense, and the result obtained after making such deductions in addition to operating and business expenses would not be the net income of the railroad but less.

With reference to the matters of rentals paid for the lines leased and operated by the railroads, the committees considered the well-known facts that these leases are usually for long terms and with numerous collateral obligations which make them amount practically to purchases of the lessor road's properties by the lessee, and that, this being true, the consideration paid for such long leases of property used fully as if operating expense, but is by clear analogy and in practical effort a capital expense. If these expenses are allowed as deductions to the plaintiffs, the result would be that they would have no income subject to tax until they had earned enough to provide not only for all business and operating expenses, but also for all capital expenses and had paid all interest on their bonds; in other words, it would amount to nothing more than a tax on the savings of railroads, which would render the tax utterly incommensurate with that imposed as income tax on individuals and other ordinary corporations.

Affiant states it as his opinion that the Income Tax Act as applied to railroads and other public service corporations under the provisions of Sec. 202 results in a strictly fair and just tax upon their net income, entirely commensurate in scope and burden with the tax imposed on other corporations and individuals, except that perhaps, in view of the fact that individuals are allowed no deduction whatever for living and family expenses, which expenses are analogous to many items allowed all corporations as deductions, the tax bears relatively more heavily on individuals than on corporations by reason of the constitutional inhibition against allowing such deductions to individuals.

As to the contention of the plaintiffs that it is arbitrary classification and discrimination to base a classification on the question whether the taxpayer is required to keep his accounts in accordance with the Standard Classification, the affiant is advised and believes, so states, that so long as all railroads are placed within the class

and are treated alike without discrimination, the classification is reasonable and not arbitrary, because the distinction of being roads and not other corporations is a practical and reasonable basis of distinction and classification. Affiant asserts further that all roads are taxed alike under the Income Tax Act of 1921. All are required to make return for taxation on Income Tax blank, form

76 according to the Standard Classification of Accounts; that the class is even broader than that of railroads, including all other public service corporations, these being required to make return on Form 8, according to the same Standard Classification, as sworn to in the affidavit of O. S. Thompson filed by the defendants herein.

When railroads keep the Standard Classification of Accounts under Federal or State requirements, the only practical method of requiring return for income tax to be made is according to the classification of accounts, and for the State to require different accounting, would conflict practically with the power of the Interstate Commerce Commission to prescribe uniform classification of accounts. The State of North Carolina has not undertaken to prescribe any system of accounting for the plaintiffs or other railroads in conflict with that already required to be kept by the Interstate Commerce Commission, but has adopted that system as the best and most practical basis for the calculation of net incomes for taxation.

A. J. MAXWELL, Affiant

Subscribed and sworn to before me this the 5 day of June, 1922.
[SEAL.] W. A. PITTMAN,

Notary Public

My commission expires July 29, 1922.

77 *Affidavit of R. O. Self.*

Filed June 5, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity,

SEABOARD AIR LINE RAILWAY COMPANY, Plaintiffs,
vs.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, et al.
Defendants.

Railroad Income Tax Suits.

Affidavit of R. O. Self.

R. O. Self, being duly sworn, deposes and says:

Affiant is the clerk of the State Corporation Commission of North Carolina, has been such since the 1st of September, 1919, and

is the custodian of the records of the said Commission and is thoroughly familiar with the administering by the Commission of duties and powers given it by statute. He is thoroughly familiar with the classification made by the Corporation Commission of corporations subject to its supervision.

Affiant has read the affidavit of Mr. A. R. Turnbull, President of Rowland Lumber Company, which affidavit is filed by the Northern Southern Railroad Company in these suits, and affiant is familiar with contents thereof. He has also read and is familiar with contents thereof. He has also read and is familiar with the contents of affidavit of Mr. Nathan O'Berry, President of the Enterpriseville Lumber Company, filed by the said plaintiff in these suits. The said Rowland Lumber Company, and the said Enterpriseville Lumber Company do what is known as a limited transportation business, and are authorized by the Commission to carry their logging roads certain limited commodities other than their property. These corporations are not railroad corporations, but lumbering corporations. Their lines of tramway, or railroad, are constructed by them for the purpose of hauling logs and lumber and operating their lumber business. When such roads are established there are frequent demands by the community through which they run for them to transport other commodities for the convenience and accommodation of the inhabitants of those communities. Under Section 3413, Consolidated Statutes, the Corporation Commission has the power to, and in proper cases does, grant authority to such logging or lumber companies to carry for hire over their logging, or tramway, roads commodities of others within certain limitations.

These corporations are not classed, considered, or treated by the Corporation Commission as railroads, but they are subjected to the supervision of the Commission, chiefly to prevent discrimination as to the very limited carrier service which they are allowed to perform. They are not classed as common carriers, in the same class as railroads such as the plaintiffs in these suits.

As to the Rowland Lumber Company, it entered into the business referred to in the affidavit of Mr. Turnbull not for profit, but purely for the accommodation of the community, as the following quotations from letters and documents will show:

Letter from Mr. A. R. Turnbull, President, Rowland Lumber Company to W. G. Womble, Rate Clerk, State Corporation Commission, Raleigh, N. C., March 22, 1918:

"It is true that we have been handling fertilizer over the west end of our road for the benefit of the people located in that territory. It is merely an accommodation to them, and is of no benefit to them."
* * * If these people do not care for this accommodation it will certainly be a great pleasure for us, under present circumstances to discontinue this hauling of freight for them, as it is done absolutely at cost to us on the present basis."

Letter from Stevens & Beasley, Attorneys for the Rowland Lumber Company, to the North Carolina Corporation Commission dated March 27, 1918. This letter after referring to complaints made by certain citizens of Faison, N. C., against the Rowland Lumber Company for alleged excessive charges for hauling fertilizer says:

"The Rowland Lumber Company is not operating a logging business, over its road, this year, in Sampson County to any extent but is confining its operations to its log road in Duplin. It has even determined to open up its road in Sampson County for the carrying of freight as charged, but was simply coming to the rescue of the farmers in Sampson County, and aiding them, as all good citizens should do, in making food for fighting Germany."

79 For all the winter the roads in that section have been almost impassible with an empty vehicle and had the farmers, many of them 15 miles from the railroad, been permitted by the roads to have hauled at all the cost would have been enormous, from \$3 to \$5 per ton and in this emergency the Rowland Lumber Company has been helping them out at great inconvenience to itself and even loss. * * * Labor conditions are such the cost of operating so high that no one except a man like Mr. Turnbull would have undertaken to deliver the fertilizer to these people and he regrets that they have been so shortsighted as to kick, for it might have been possible for the road to have been developed into a public carrier under his generous impulses and public spirit. In building the Atlantic Carolina Railroad, he has done more for Duplin County than any other one man."

The authority granted to the Rowland Lumber Company, aforesaid, was granted pursuant to petition filed by the Rowland Lumber Company with the Corporation Commission, copy of which is attached hereto and marked Exhibit "A," and which petition shows that it was made purely to accommodate citizens, who requested such service of the Rowland Lumber Company.

On the 27th of February, 1922, Mr. A. R. Turnbull, President of the Rowland Lumber Company, addressed another letter to W. G. Womble, Rate Clerk, Corporation Commission, in which he said:

"As you will understand we are not operating on piece of land west of Bowden, but are simply handling fertilizer, etc., for the commodation of people in that territory. We would be much ahead by discontinuing this service, and will do so if you deem it necessary, but in the meantime, we will do the best we can to give them all the service possible. We have left one locomotive at Bowden to attend to this business and hope to give them better service this year than we have in the past. On the two points, New Grove and Eureka Church, however, there will be some delay, we have notified all shippers whom we know that we do not intend to handle this business except in that way."

There is attached hereto and marked Exhibit "B," a schedule of the rates of the Enterprise-Whiteville Lumber Company over its logging road, effective December 1, 1920, as filed with the Corporation Commission, which schedule shows the limitation as to the commodities carried and allowed to be carried by this road.

These logging roads and others similar to them are not classed as railroads and as full common carriers by the Corporation Commission for the reasons above shown, for the reason that their business carriage of property of others is purely incidental to their business of logging and manufacturing lumber, and is negligible in amount, and for the reason that they maintain no regular schedule of trains, but run simply when there is particular demand for a particular carriage.

R. O. SELF,

Affiant.

Subscribed and sworn to before me this 5 day of June, 1922.

[SEAL.]

W. H. PITTMAN,

Notary Public.

My commission expires July 29, 1922.

EXHIBIT "A."

Rowland Lumber Company.

Norfolk, Va., May 21, 1918.

To the Corporation Commission of North Carolina:

The Rowland Lumber Company respectfully sheweth to the Corporation Commission of North Carolina:

1. That it is a corporation incorporated under the laws of the State of North Carolina, authorized to engage in the Lumber business. In the operation of its timber it has purchased, and caused to be constructed, for logging purposes, a line of railroad running from Greens and Warsaw, on the Atlantic Coast Line Railroad, in Duplin County, North Carolina, in a westerly direction for about twenty miles toward Newton Grove.

2. Your petitioner has been, and is continuously being, requested by the citizens living along the line of this road to transport freight for them and others; your petitioner is willing to accommodate such parties under present conditions, provided it can do so lawfully.

3. Under Revisal of 1905, Sec. 2598, as amended by Chapter 160, Laws of 1911, your Honorable Body is empowered to authorize this company to transport commodities, and to charge therefor reasonable rates, in addition to the transportation of its own commodities:

Wherefore, your petitioner respectfully prays, that your Honorable Body authorize your petitioner to transport over its logging road as freight, commodities in carload lots, but excluding lumber and logs, purchased and used along the line of said road, and to make charges therefor; and that this authority be continued from year to year until your petitioner shall give to this Honorable Body necessary notice of its intention to discontinue said service.

Respectfully submitted,

(S.) ROWLAND LUMBER COMPANY,
By A. R. TURNBULL,
President & General Mgr.

EXHIBIT "B."

Rates of Enterprise Lumber Company Railroad.

Effective December 1, 1920.

Fruit and vegetables, per crate.....	20	20	25	25	25
Fruits and vegetables, per car.....	1500	1650	2000	2250	2500
Empty Crates or Barrels, " ".....	1500	1650	2000	2250	2500
Ditto each.....	10	10	12½	15	15
Fertilizers, 20 Tons Maximum.....	2500	2600	3250	3500	4000
Fertilizers from 10 to 20 tons, per ton minimum 1,500 per car.....	150	175	200	225	275
L. C. L. per ton.....	300	300	350	400	450
Cotton Seed and Hulls.....	2000	2200	2700	3000	3300
L. C. L. per ton.....	200	250	300	375	400
Holly, Lime and Flour in carload.....	2000	2200	2600	2800	3000
Wood—Minimum 10 cords, per c.....	100	100	110	125	150
Cotton, per bale.....	150	150	150	175	175
Furniture, per 100 pounds.....	25	27	30	30	35
Chickens and eggs, per crate.....	30	20	30	30	30
Mdse. not classed, per 100.....	20	20	25	25	30
Brick, minimum 10 per m.....	300	300	300	300	350

All freight is to be loaded and unloaded at expense and risk of shipper. We will not accept any freight either earload or L. C. L. from or to any point except the following:

Oliver's Siding.....	3
Taylor's Siding.....	3 $\frac{1}{2}$
Loftin's Siding.....	3 $\frac{3}{4}$
King's Crossing.....	5 $\frac{1}{2}$
Dobson's Crossing.....	7 $\frac{1}{2}$
Hill's or Cherry's Siding.....	9 $\frac{1}{2}$
Scott's Store.....	12
Brown's Camp or Snow Hill.....	13
Woodland Siding C. L. only.....	16
Kornegay's Bridge " ".....	17

All cars have to — unloaded on the same day they are placed, or demurrage will be charged. No freight will be shipped collect. Package freight will be carried out only on Fridays and if placed in warehouses on any day previous to Thursday it will be held by this Company at the shipper's risk. Earload shipments will be taken out any day in the week.

ENTERPRISE LUMBER COMPANY
THOMAS O'BERRY,
General Mgr.

82

Affidavit of F. C. Harding.

Filed June 20, 1922.

In Equity.

No. 447.

SEABOARD AIR LINE RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue, et al.

F. C. Harding, being duly sworn, deposes and says, that he is the President of the Greenville and Shelberdine Railroad Company; that the same was chartered in 1920; that the road is 12 miles long, extending from Greenville to Shelberdine and is of narrow gauge. That W. L. Hall is the Secretary of said Railroad Company and that David Hoots is General Superintendent, Engineer and Conductor. That this road has no office, either in Greenville or at Shelberdine or along the route of its railroad. That this road makes, as a general thing, one trip a day.

During the movement of fertilizer in the spring, it often makes two trips a day. That it carries freight for hire, from Greenville to any point along the road to Shelberdine and from Shelberdine to any point along the road to Greenville. That it issues no bills of lading. That the freight it carries from Greenville to Shelberdine, or along

the route, is removed from the Atlantic Coast Line Railroad Co. cars and placed in this company's car and is delivered along the route to its several patrons. That while people along the route use this road as a convenience to travel, this company has never charged any passenger rates. That this company has never made any report to the State Corporation Commission or to the Internal Revenue Commissioner and of course has never made any interstate report as it does not do any interstate business as all of its business is intrastate. That this road is not a lumber road. It was originally built for a lumber road but when the Beaufort County Lumber Co., removed from Pitt County, the road was purchased by the present owners who afterwards incorporated under the style above named.

83 Affiant further states that the Greenville and Shelbournine Railroad Company does not keep its accounts according to the standard classification of accounts promulgated by the Interstate Commerce Commission.

F. C. HARDING.

Subscribed and sworn to before me this 20th day of June 1922.

[SEAL.]

M. V. HARDING,
Notary Public.

My commission expires Nov. 3, 1922.

84 Affidavit of J. C. Nelms, Jr. (May 17, 1922).

Filed June 20, 1922.

In Equity.

No. 447.

SEABOARD AIR LINE RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue, et al.

J. C. Nelms, Jr., being first duly sworn, deposes and says: That he is General Auditor of Norfolk Southern Railroad Company; that during the year 1921, Norfolk Southern Railroad Company operated a line of railroad owned by Carthage & Pinehurst Railroad Company, extending from Pinchurst to Carthage, North Carolina, under a lease which had expired, the reason for the continued operation thereof being that it had been prohibited by the laws of the United States to abandon said line of railroad unless permission was granted by the Interstate Commerce Commission;

That during the year 1921, it paid as rent for the use of said property in the business or trade of Norfolk Southern Railroad Company the rent stipulated to be paid in said lease.

That Norfolk Southern Railroad Company had not taken title to and was not taking title to said property, and had no equity therein.
J. C. NELMS, JR.

Subscribed and sworn to before me this 17th day of May, 1922.
[SEAL.] GILBERT C. REVEILLE,
Notary Public.

My commission expires on the 31st day of August 1924.

85 *Affidavit of J. C. Nelms, Jr. (May 18, 1922).*

Filed June 20, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

SEABOARD AIR LINE RAILWAY COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.
Defendants.

Affidavit.

J. C. Nelms, Jr., being first duly sworn, deposes and says:

That he is a citizen and resident of the County of Norfolk, and State of Virginia; that he is General Auditor of Norfolk Southern Railroad Company and has occupied that position since April, 1915; that he is familiar with the rules of accounting for steam and electric railroads as prescribed by the Interstate Commerce Commission.

On the 19th of May, 1914, effective July 1, 1914, the Interstate Commerce Commission issued orders classifying the accounts of steam railroads, and dividing the accounts into two classes:

- (1) Operating Revenues and Operating Expenses; and,
- (2) Income, Profit and Loss, and General Balance Sheet Accounts.

These rules are still in force, subject to such modifications and explanations as have been made by the Commission since that date.

That the order prescribing the classification of Operating Revenues and Operating Expenses of Steam Roads, among other things provided:

"It is ordered, That, the Classification of Operating Revenues and Operating Expenses of Steam Roads and the text pertaining thereto, embodied in printed form to be hereafter known as Issue of 1914, a copy of which is now before this Commission, be, and is hereby, approved; that a copy thereof duly authenticated by the Secretary of the Commission be filed in its archives, and a second copy thereof

in like manner authenticated, in the office of the Division of Carriers' Accounts; and that each of said copies so authenticated and filed shall be deemed an original record thereof.

"It is further ordered, That the said Classification of Operating Revenues and Operating Expenses of Steam Roads, with the text pertaining thereto, be, and is hereby, prescribed for the use of carriers by rail (exclusive of electric railways) subject to the provisions of the Act to Regulate Commerce as amended, in the keeping and recording of their operating revenue and operating expense accounts; that each and every such carrier and each and every receiver or operating trustee of any such carrier be required to keep all operating revenue and operating expense accounts in conformity therewith; and that a copy of said issue be sent to each and every such carrier and to each and every receiver or operating trustee of any such carrier."

This affiant has a copy of the said order and the classification of accounts and instructions accompanying the same.

Accompanying said order, as sent to the carriers, was an introductory letter, which among other things stated that:

"Accounts are provided in this classification for the revenues and expenses of operations which heretofore have been classed as auxiliary or outside operations. The purpose in merging these accounts has been to secure a statement of revenues and expenses in connection with the operation of all physical property the cost of which is includible in the accounts for investment in road and equipment. The accounts for maintenance of physical property have been arranged to correspond with those for the investment in such property. Depreciation accounts have been provided for the current depreciation of fixed improvements, although until further directed the recognition in operation expenses of current depreciation of fixed improvements is optional with the carrier. It is provided that organization and general administration expenses directly assignable to investments in stocks, bonds, and other securities shall be excluded from the accounts of this classification and included in income account No. 549, 'Maintenance of investment organization.'"

There also accompanied said order and classification certain general instructions, among which were the following:

"1. Operating Accounts.—The accounts of this classification are designed to show the revenues and expenses (including the maintenance of the facilities used) of the carrier's railway operations, including rail-line transportation, water-line transportation, if any, and services incident to transportation. Transportation includes the receipt, conveyance, and delivery of traffic."

"4. Miscellaneous Operations.—The revenue and expenses of miscellaneous operations involving the use of such facilities as hotels and restaurants, power plants, cold-storage plants, coal-storage plants, cotton compress plants, wood-preserving plants, ice-supply plants, etc.,

shall not be included in the accounts of this classification when the facilities used are distinct from those used by the carrier in the service of transportation or in the maintenance of facilities used in transportation service, and the operations are not incident to such service. (See income accounts No. 502, "Revenue from miscellaneous operations," and No. 534, "Expenses of miscellaneous operations," and balance-sheet account No. 705, "Miscellaneous physical property.")"

There also accompanied said order certain special instructions, among which was:

"1. Accounts for Operating Revenues.—The accounts provided for operating revenues are designed to show amounts of money which a carrier becomes entitled to receive from transportation and from operations incident thereto."

The Operating Revenue accounts were by the said classification divided into general accounts and primary accounts. A statement of the general accounts and primary accounts for steam railroads, according to the said classification, showing the number of each account, as set out in said rule and order is hereto attached marked Exhibit A and prayed to be taken as a part of this affidavit.

The said order prescribed that account 142 "Rents of Buildings and other property," should include: "the revenue from the exclusive use of buildings and other property or portions thereof, such as depot and station grounds and buildings, general and other offices, wharves, ferry landings, elevators, stockyards, fuel yards, enginehouses, repair shops, and section and other houses, when the property is operated and maintained in connection with the property used in the carrier's transportation operations and the expenses of maintaining and operating the rented portion cannot be separated from the expenses of that portion used by the carrier."

As to the General Account No. IV, Joint Facility, being primary accounts Nos. 151 and 152, the said order provides that these accounts should include the carrier's proportion of revenue collected by others in connection with the operation of joint tracks, yards, terminals and other facilities, and also that proportion of revenue from the operation of joint tracks, yards terminals and other facilities, which is creditable to other companies.

The account did not include the rent paid for the use of the joint facilities, simply results of operations.

The operating expenses were by said order divided into eight general accounts, and into quite a number of primary accounts. A statement is hereto attached showing the general and primary accounts of steam railroads. Said statement is marked Exhibit B and is prayed to be taken as a part hereof.

The special instructions accompanying said order, among other things, stated that: "The accounts prescribed for operating expenses are designed to show expenses of furnishing transportation

tion service, including the expenses of maintaining the plant used in the service."

The accounts of Norfolk Southern Railroad Company are and have been kept in accordance with the rules and regulations prescribed by the Interstate Commerce Commission as set out in said orders, as explained by the instructions and orders of the Commission, modifying or explaining the aforesaid order of May 19, 1914.

The said accounts and reports made to the Commission in accordance with said rules and regulations do not contain any such term as "Net Operating Income." The reports of Norfolk Southern Railroad Company made to the Interstate Commerce Commission show the total amount of its operating revenues and also shows the total amount of its operating expenses, and also the difference between these two amounts, which in said reports, and under the rules prescribed by the Interstate Commerce Commission, is denominated and known as "Net Revenue from Railway Operations." The Net Revenue from Railway Operations of Norfolk Southern Railroad Company and of corporations operating steam or electric railroads, keeping their accounts in accordance with the standard classification of accounting of the Interstate Commerce Commission, is the difference between the amount of money which Norfolk Southern Railroad Company or such other similar corporations, receives from transportation, as the term "Transportation" is defined in the said classification of accounts and in the Interstate Commerce Act, and the amount paid out for "all the ordinary and necessary expenses paid during the income year for conducting and carrying on transportation, as transportation is defined in the said classification of accounts and in the Interstate Commerce Act, including as a part of said expenses depreciation on its equipment, to-wit: steam locomotives, other locomotives, freight train cars, passenger train cars, motor equipment of cars, floating equipment, work equipment and miscellaneous equipment, if any."

Accounts of operating revenues and operating expenses of steam railroads, such as Norfolk Southern Railroad Company, and other similar corporations, kept in accordance with standard classification of accounting of the Interstate Commerce Commission do not include all gain derived from capital or labor or both combined, provided it is understood that the term "gain" includes profit gained through a sale or conversion of capital assets.

The said operating revenues and operating expenses of steam roads does not include the following items of gain or income which such corporations may receive during any period of time, but said items or sources of revenue or gain are in accordance with said classification carried under what is known as income accounts, to-wit: revenues from miscellaneous operations, hire of freight cars, credit balance, rents from locomotives, rents from passenger train cars, rents from floating equipment, rents from work equipment, joint facility rent income, income from lease of road, miscellaneous rent income, miscellaneous non-operating physical property, separately operated properties,—profit, dividend income, income from funded securities, income from unfunded securities and accounts, in-

come from sinking and other reserve funds, release of premiums on funded debt, contributions from other companies, and miscellaneous income, all of which are gain from labor or capital or both combined, or from a sale or conversion of capital assets.

The accounts of operating revenues and operating expenses of steam railroads, when such accounts are kept in accordance with the standard classification of accounting of Interstate Commerce Commission, do not include all of the expenses of conducting and carrying on the business of the corporation, and do not include many items of expenses which are necessary to be paid in order that the business may be carried on, to-wit: railway tax accruals; uncollectible railway revenues; expenses of miscellaneous operations; taxes on miscellaneous operating property; hire of freight cars—debit balance; rent for locomotives; rent for passenger-train cars; rent for floating equipment; rent for work equipment; joint facility rents; rent for leased roads; miscellaneous rents; miscellaneous tax accruals; separately operated properties—loss; interest on funded debt; interest on unfunded debt; amortization of discount on funded debt; maintenance of investment organization; income transferred to other companies; miscellaneous income charges; income applied to sinking and other reserve funds; dividend appropriations of income; income appropriated for investment in physical property; stock discount extinguished through income; and miscellaneous appropriations of income.

Under the aforesaid orders of the Interstate Commerce Commission dividing the accounts of corporations, operating steam railroads engaged in interstate commerce, into the two general classes as aforesaid, to-wit: Operating Revenues and Operating Expenses on the one part, and Income, Profit and Loss, and General Balance Sheet Accounts on the other, the Interstate Commerce Commission prescribed with great care and particularity the items of revenue which should go into each of the income accounts both credit and debit accounts.

A list of the primary accounts constituting the income accounts under said classification, both credit and debit is hereto attached marked Exhibit C and prayed to be taken as a part hereof.

In addition, the said order of the Commission in prescribing rules of accounting for corporations operating steam railroads engaged in interstate commerce, prescribed a form of income statement. A copy of said form is hereto attached and made a part hereof, marked Exhibit D, and prayed to be taken as a part hereof.

90 The accounts of Norfolk Southern Railroad Company are kept in accordance with the aforesaid classification, its income statement is made to accord with the form of income statement prescribed in said rules of accounting and it reports to the Interstate Commerce Commission its operating revenues, operating expenses and other items of intake and outgo, all as prescribed by the Interstate Commerce Commission.

The term "Operation Ratio" does not appear in said rules of accounting. The term "operating ratio" is generally understood to mean and be that percent which the operating expenses as prescribed by the Interstate Commerce Commission bears to the operating revenues as prescribed by the Interstate Commerce Commission.

The difference between the operating revenue and operating expenses of a corporation operating the steam railroads in keeping its accounts in accordance with the rules of the Interstate Commerce Commission does not show or purport to show the net income of such corporations, but purports to show and shows the difference between the amount of revenue received from the business of conducting and carrying on its transportation and the operations incident thereto and the cost and expense of conducting such transportation and the incidents thereto.

In order to obtain the net income of such corporations it is necessary to consider and take into consideration the income accounts of said corporation as prescribed and shown in the rules of accounting of the Interstate Commerce Commission, and is set out in the form of income statement prescribed by the Commission, and which such railroad companies are required to make to the Commission.

Norfolk Southern Railroad Company owns and operates a line of electric railroad which runs from Norfolk to Virginia Beach and thence to Cape Henry, thence returning to Norfolk. In making reports to the Interstate Commerce Commission under the orders of the Commission the accounts of the electric division and the steam division are combined. Under permission granted by the Interstate Commerce Commission, Norfolk Southern Railroad Company keeps records showing the accounts of the electric division or electric railroad separate from the steam division or steam railroad. No part of the electric railroad is situated in North Carolina. The steam railroad extends and is situated both in North Carolina and Virginia. The ratio of operating expenses to operating revenue of the electric division was for the year 1921, 74.37% and for the steam division 84.51%, and for the entire system including both steam and electric divisions, 83.81%. That is to say that out of every dollar received by Norfolk Southern Railroad Company in payment for services rendered in the conduct of transportation on its electric division, as transportation is defined in classification of accounts of the Interstate Commerce Commission, it paid out in operating expenses, as such operating expenses are defined in said classification of accounts, 74.37 cents. That of its steam division, which is located partly in North Carolina and partly in Virginia, where the business is both local and through, in both states, out of every dollar taken in for services rendered in the conduct of transportation, both intra and interstate, it became necessary to pay, and the company did pay in operating expenses as operating expenses are defined in said classification, the sum of 84.51 cents. That considering its entire system, both electric and steam, out of every dollar taken in payment for services rendered in transportation, both interstate and intrastate, as transportation is defined in the standard classification of accounting of the Interstate Commerce Commission, it becomes necessary for Norfolk Southern Railroad Company to pay for operating expenses in conducting transportation, as transportation is defined in the classification of accounting of the Interstate Commerce Commission 83.81 cents.

That in addition to the operating expenses aforesaid it became necessary for Norfolk Southern Railroad Company, in order to conduct and carry on its business and especially its business on steam division, to pay sums and items as set out in section 23 of the bill of complaint filed in this case.

During the calendar year 1921, which was the income year 1922 Norfolk Southern Railroad Company paid expenses for conducting and carrying on its business which are not included under the head of operating expenses under the rules of accounting of the Interstate Commerce Commission, as follows, to-wit:

Joint Facility Rents, that is rents for tracks, yards, terminals and other facilities owned or controlled by other carriers, companies or individuals, and in the joint use of which Norfolk Southern Railroad Company participated, in the sum of \$37,366.96 of which \$36,009.76 was allocatable in that part of the road located in North Carolina.

For rent of roads, tracks or bridges, including equipment and other railway property covered by the contract of lease of other companies held under lease or other agreement, by the terms of which the exclusive use and control for operating purposes are secured, the sum of \$160,365.96, the entire amount of which was for properties located in North Carolina.

For the use of miscellaneous property, that is property which was not used in the operation of the railroad, but used in the conducting its business and necessary so to be used, the sum of \$1,376.63 of which \$372.83 was allocatable to North Carolina.

For interest on its funded debt the sum of \$884,399.57 of which \$778,351.22 was and is allocatable to the State of North Carolina.

For interest on unfunded debt \$37,025.96, of which \$32,587.00 was allocatable to North Carolina.

92 For amortization of discount on funded debt, being a proportion of the discount and expense on funded debt of the company applicable to that period, in accordance with the standard rules of accounting of the Interstate Commerce Commission \$21,719.53 of which \$21,755.41 was and is allocatable to North Carolina.

Other expenses of conducting and carrying on its business which in the standard classification of accounting of the Interstate Commerce Commission is designated as miscellaneous income charges the sum of \$57,697.34, of which \$50,776.85 is allocatable to the State of North Carolina.

That Norfolk Southern Railroad Company had not taken title, was not taking title, and had no equity in any of the properties leased including the railroads or joint facilities, and which are referred to as having been secured for its use in the conduct of its business by payment of the rents aforesaid.

That under the orders of the Commission, the form of accounting prescribed for operating expenses carried accounts "for the current depreciation of fixed improvements." The said orders and instructions further provided that the recognition of and charging out of operating expenses current depreciation of fixed improvements was optional with the carrier. Norfolk Southern Railroad Company

any has never charged out in its operating expenses any current appreciation for fixed improvements.

(S)

J. C. NELMS, JR.

Sworn and subscribed to before me this 18 day of May, 1922.

(S)

GILBERT C. REVEILLE,

Notary Public.

[SEAL.]

My commission expires on the 31st day of August, 1924.

EXHIBIT A.

Operating Revenue Accounts.

General Accounts.

- I. Transportation—Rail Line.
- II. Transportation—Water Line.
- III. Incidental.
- IV. Joint Facilities.

Primary Accounts.

I. Transportation—Rail line:

101. Freight.
102. Passenger.
103. Excess baggage.
104. Sleeping car.
105. Parlor and chair car.
106. Mail.
107. Express.
108. Other passenger-train.
109. Milk.
110. Switching.
111. Special service train.
112. Other freight-train.
113. Water transfers—Freight.
114. Water transfers—Passenger.
115. Water transfers—Vehicles and live stock.
116. Water transfers—Other.

II. Transportation—Water line—

121. Freight.
122. Passenger.
123. Excess baggage.
124. Other passenger service.
125. Mail.
126. Express.
127. Special service.
128. Other.

III. Incidental—

- 131. Dining and buffet.
- 132. Hotel and restaurant.
- 133. Station, train, and boat privileges.
- 134. Parcel room.
- 135. Storage—Freight.
- 136. Storage—Baggage.
- 137. Demurrage.
- 138. Telegraph and telephone.
- 139. Grain elevator.
- 140. Stockyard.
- 141. Power.
- 142. Rents of buildings and other property.
- 143. Miscellaneous.

IV. Joint Facility—

- 151. Joint Facility—Cr.
- 152. Joint Facility—Dr.

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EXHIBIT B.

Operating Expense Accounts.

General Accounts.

- I. Maintenance of Way and Structures.
- II. Maintenance of Equipment.
- III. Traffic.
- IV. Transportation—Rail line.
- V. Transportation—Water line.
- VI. Miscellaneous operations.
- VII. General.
- VIII. Transportation for investment—Cr.

Primary Accounts.

I. Maintenance of Way and Structures—

- 201. Superintendence.
- 202. Roadway maintenance.
- 203. Roadway—Depreciation.
- 204. Underground power tubes.
- 205. Underground power tubes—Depreciation.
- 206. Tunnels and subways.
- 207. Tunnels and subways—Depreciation.
- 208. Bridges, trestles, and culverts.
- 209. Bridges, trestles, and culverts—Depreciation.
- 210. Elevated structures.
- 211. Elevated structures—Depreciation.
- 212. Ties.

213. Ties—Depreciation.
214. Rails.
215. Rails—Depreciation.
216. Other track material.
217. Other track material—Depreciation.
218. Ballast.
219. Ballast—Depreciation.
220. Track laying and surfacing.
221. Right-of-way fences.
222. Right-of-way fences—Depreciation.
223. Snow and sand fences and snowsheds.
224. Snow and sand fences and snowsheds—Depreciation.
225. Crossings and signs.
226. Crossings and signs—Depreciation.
227. Stations and office buildings.
228. Stations and office buildings—Depreciation.
229. Roadway buildings.
230. Roadway buildings—Depreciation.
231. Water stations.
232. Water stations—Depreciation.
233. Fuel stations.
234. Fuel stations—Depreciation.
235. Shops and enginehouses.
236. Shops and enginehouses—Depreciation.
237. Grain elevators.
238. Grain elevators—Depreciation.
239. Storage warehouses.
240. Storage warehouses—Depreciation.
241. Wharves and docks.
242. Wharves and docks—Depreciation.
243. Coal and ore wharves.
244. Coal and ore wharves—Depreciation.
245. Gas producing plants.
246. Gas producing plants—Depreciation.
247. Telegraph and telephone lines.
248. Telegraph and telephone lines—Depreciation.
249. Signals and interlockers.
250. Signals and interlockers—Depreciation.
251. Power plant dams, canals, and pipe lines.
252. Power plant dams, canals, and pipe lines—Depreciation.
253. Power plant buildings.
254. Power plant buildings—Depreciation.
255. Power substation buildings.
256. Power substation buildings—Depreciation.
257. Power transmission systems.
258. Power transmission systems—Depreciation.
259. Power distribution systems.
260. Power distribution systems—Depreciation.
261. Power line poles and fixtures.
262. Power line poles and fixtures—Depreciation.

- 263. Underground conduits.
- 264. Underground conduits—Depreciation.
- 265. Miscellaneous structures.
- 266. Miscellaneous structures—Depreciation.
- 267. Paving.
- 268. Paving—Depreciation.
- 269. Roadway machines.
- 270. Roadway machines—Depreciation.
- 271. Small tools and supplies.
- 272. Removing snow, ice and sand.
- 273. Assessments for public improvements.
- 274. Injuries to persons.
- 275. Insurance.
- 276. Stationery and printing.
- 277. Other expenses.
- 278. Maintaining joint tracks, yards, and other facilities
Dr.
- 279. Maintaining joint tracks, yards, and other facilities
Cr.

II. Maintenance of Equipment—

- 301. Superintendence.
- 302. Shop machinery.
- 303. Shop machinery—Depreciation.
- 304. Power plant machinery.
- 305. Power plant machinery—Depreciation.
- 306. Power substation apparatus.
- 307. Power substation apparatus—Depreciation.
- 308. Steam locomotives—Repairs.
- 309. Steam locomotives—Depreciation.
- 310. Steam locomotives—Retirements.
- 96 311. Other locomotives—Repairs.
- 312. Other locomotives—Depreciation.
- 313. Other locomotives—Retirements.
- 314. Freight-train cars—Repairs.
- 315. Freight-train cars—Depreciation.
- 316. Freight-train cars—Retirements.
- 317. Passenger-train cars—Repairs.
- 318. Passenger-train cars—Depreciation.
- 319. Passenger-train cars—Retirements.
- 320. Motor equipment of cars—Repairs.
- 321. Motor equipment of cars—Depreciation.
- 322. Motor equipment of cars—Retirements.
- 323. Floating equipment—Repairs.
- 324. Floating equipment—Depreciation.
- 325. Floating equipment—Retirements.
- 326. Work equipment—Repairs.
- 327. Work equipment—Depreciation.
- 328. Work equipment—Retirements.
- 329. Miscellaneous equipment—Repairs.

- 330. Miscellaneous equipment—Depreciation.
- 331. Miscellaneous equipment—Retirements.
- 332. Injuries to persons.
- 333. Insurance.
- 334. Stationery and printing.
- 335. Other expenses.
- 336. Maintaining joint equipment at terminals—Dr.
- 337. Maintaining joint equipment at terminals—Cr.

III. Traffic—

- 351. Superintendence.
- 352. Outside agencies.
- 353. Advertising.
- 354. Traffic associations.
- 355. Fast freight lines.
- 356. Industrial and immigration bureaus.
- 357. Insurance.
- 358. Stationery and printing.
- 359. Other expenses.

IV. Transportation—Rail line—

- 371. Superintendence.
- 372. Dispatching trains.
- 373. Station employees.
- 374. Weighing, inspection, and demurrage bureaus.
- 375. Coal and ore wharves.
- 376. Station supplies and expenses.
- 377. Yardmasters and yard clerks.
- 378. Yard conductors and brakemen.
- 379. Yard switch and signal tenders.
- 380. Yard enginemen.
- 381. Yard motormen.
- 382. Fuel and yard locomotives.
- 383. Yard switching power produced.
- 384. Yard switching power purchased.
- 385. Water for yard locomotives.
- 386. Lubricants for yard locomotives.
- 387. Other supplies for yard locomotives.
- 388. Enginehouse expenses—Yard.
- 389. Yard supplies and expenses.
- 390. Operating joint yards and terminals—Dr.
- 391. Operating joint yards and terminals—Cr.
- 392. Train enginemen.
- 393. Train motormen.
- 394. Fuel for train locomotives.
- 395. Train power produced.
- 396. Train power produced purchased.
- 397. Water for train locomotives.
- 398. Lubricants for train locomotives.
- 399. Other supplies for train locomotives.

- 400. Enginehouse expenses—Train.
- 401. Trainmen.
- 402. Train supplies and expenses.
- 403. Operating sleeping cars.
- 404. Signal and interlocker operation.
- 405. Crossing protection.
- 406. Drawbridge operation.
- 407. Telegraph and telephone operation.
- 408. Operating floating equipment.
- 409. Express service.
- 410. Stationery and printing.
- 411. Other expenses.
- 412. Operating joint tracks and facilities—Dr.
- 413. Operating joint tracks and facilities—Cr.
- 414. Insurance.
- 415. Clearing wrecks.
- 416. Damage to property.
- 417. Damage to live stock on right of way.
- 418. Loss and damage—Freight.
- 419. Loss and damage—Baggage.
- 420. Injuries to persons.

V. Transportation—Water line—

- 431. Operation of vessels.
- 432. Operation of terminals.
- 433. Incidental.

VI. Miscellaneous operations—

- 441. Dining and buffet service.
- 442. Hotels and restaurants.
- 443. Grain elevators.
- 444. Stockyards.
- 445. Producing power sold.
- 446. Other miscellaneous operations.

VII. General—

- 451. Salaries and expenses of general officers.
- 452. Salaries and expenses of clerks and attendants.
- 453. General office supplies and expenses.
- 98 454. Law expenses.
- 455. Insurance.
- 456. Relief department expenses.
- 457. Pensions.
- 458. Stationery and printing.
- 459. Valuation expenses.
- 460. Other expenses.
- 461. General joint facilities—Dr.
- 462. General joint facilities—Cr.

VIII. Transportation for investment—Cr.

EXHIBIT C.

Income Accounts.

Primary Accounts.

I. Credits:

501. Railway operating revenues.
502. Revenues from miscellaneous operations.
503. Hire of freight cars—Credit balance.
504. Rent from locomotives.
505. Rent from passenger-train cars.
506. Rent from floating equipment.
507. Rent from work equipment.
508. Joint facility rent income.
509. Income from lease of road.
510. Miscellaneous rent income.
511. Miscellaneous non-operating physical property.
512. Separately operated properties—Profit.
513. Dividend income.
514. Income from funded securities.
515. Income from unfunded securities and accounts.
516. Income from sinking and other reserve funds.
517. Release of premiums on funded debt.
518. Contributions from other companies.
519. Miscellaneous income.

II. Debits:

531. Railway operating expenses.
532. Railway tax accruals.
533. Uncollectible railway revenues.
534. Expenses of miscellaneous operations.
535. Taxes on miscellaneous operating property.
536. Hire of freight cars—Debit balance.
537. Rent for locomotives.
538. Rent for passenger-train cars.
539. Rent for floating equipment.
540. Rent for work equipment.
541. Joint facility rents.
542. Rent for leased roads.
543. Miscellaneous rents.
544. Miscellaneous tax accruals.
545. Separately operated properties—Loss.
546. Interest on funded debt.
547. Interest on unfunded debt.
548. Amortization of discount on funded debt.
549. Maintenance of investment organization.
550. Income transferred to other companies.
551. Miscellaneous income charges.

- 552. Income applied to sinking and other reserve funds.
- 553. Dividend appropriations of income.
- 554. Income appropriated for investment in physical property.
- 555. Stock discount extinguished through income.
- 556. Miscellaneous appropriations of income.

EXHIBIT D.

Form of Income Statement.

I. Operating income—

- 501. *Railway operating revenues.
- 531. *Railway operating expenses.
- *Net revenue from railway operations.
- 532. *Railway tax accruals.
- 533. *Uncollectible railway revenues.
- *Railway operating income.
- 502. Revenues from miscellaneous operations.
- 534. Expenses of miscellaneous operations.
- Net revenue from miscellaneous operations.
- 535. Taxes on miscellaneous operating property.
- Miscellaneous operating income.
- Total operating income.

II. Non-operating Income—

- 503. Hire of freight cars—Credit balance.
- 504. Rent from locomotives.
- 505. Rent from passenger-train cars.
- 506. Rent from floating equipment.
- 507. Rent from work equipment.
- 508. Joint facility rent income.
- 509. Income from lease of road.
- 510. Miscellaneous rent income.
- 511. Miscellaneous non-operating physical property.
- 512. Separately operated properties—Profit.
- 513. Dividend income.
- 514. Income from funded securities.
- 515. Income from unfunded securities and accounts.
- 516. Income from sinking and other reserve funds.
- 517. Release of premiums on funded debt.
- 518. Contributions from other companies.
- 519. Miscellaneous income.
- Total non-operating income.
- Gross income (or loss).

*Includes operations of water lines, if any.

III. Deductions from gross income:

- 536. Hire of freight cars—Debit balance.
- 537. Rent for locomotives.
- 538. Rent for passenger-train cars.
- 539. Rent for floating equipment.
- 540. Rent for work equipment.
- 541. Joint facility rents.
- 542. Rent for leased roads.
- 543. Miscellaneous rents.
- 544. Miscellaneous tax accruals.
- 545. Separately operated properties—Loss.
- 546. Interest on funded debt.
- 101 547. Interest on unfunded debt.
- 548. Amortization of discount on funded debt.
- 549. Maintenance of investment organization.
- 550. Income transferred to other companies.
- 551. Miscellaneous income charges.
- Total deductions from gross income.
- Net income (or loss).

IV. Disposition of Net Income:

- 552. Income applied to sinking and other reserve funds.
- 553. Dividend appropriations of income.
- 554. Income appropriated for investment in physical property.
- 555. Stock discount extinguished through income.
- 556. Miscellaneous appropriations of income.
- Total appropriations.
- Income balance transferred to credit (or debit) of Profit and Loss.

102 *Affidavit of J. C. Nelms, Jr. (June 12, 1922).*

Filed June 20, 1922.

In Equity.

No. 447.

SEABOARD AIR LINE RAILWAY COMPANY

vs.

A. D. WATTS et al.

J. C. Nelms, Jr., being first duly sworn, deposes and says; that: Accompanying and constituting a part of the order of the Interstate Commerce Commission, made the 19th day of May, 1914, effective July 1st, 1914, and still in force, with such modifications and amendments as may have been made thereto, were certain special instructions of which No. 1 reads as follows:

"Income accounts are those designed to show, as nearly as practicable, for each fiscal period, the total amount of money that a carrier becomes entitled to receive for services rendered, the returns accrued upon investments, the accrued costs paid or payable for the services rendered by it, the losses sustained by it, the amounts accrued for taxes, for use of moneys and for use of properties of others, and the appropriations made from income during the period. The net balance of income (or loss) shall be carried to Profit and Loss."

The order above referred to is the order of the Commission regulating the keeping of records by Interstate Carriers by Railroad, known as "Classification of Income, Profit and Loss, and General Balance Sheet Accounts for Steam Roads."

J. C. NELMS, Jr.

Sworn and subscribed to before me this 12th day of June, 1922

[SEAL.]

GILBERT C. REVEILLE,

Notary Public.

My commission expires the 31st day of August, 1924.

103 *Testimony of R. O. Self at Hearing Before Judge Connor.*

It is agreed that all affidavits filed in the cause by either of the plaintiffs or by the defendants will be treated as in evidence in all cases.

Mr. R. O. Self, Clerk of the North Carolina Corporation Commission produced a list of the corporations operating as limited common carriers in North Carolina under authority granted by the State Corporation Commission under section 3413 of the Consolidated Statutes of North Carolina. Also a memorandum adding two other roads was attached, all filed as Exhibit A.

R. O. SELF, witness for the defendant, examined by Judge Manning, testifies as follows:

That the several roads mentioned in Exhibit A were lumber roads for logging purposes, operating under Section 3413 of the Consolidated Statutes as a limited carrier, with the right to stop at anytime

104 EXHIBIT "A" TO TESTIMONY OF R. O. SELF.

Office of the Corporation Commission.

STATE OF NORTH CAROLINA:

This is to certify, that the Corporation Commission of North Carolina, acting under power vested in it by Sec. 3413 of the Consolidated Statutes of North Carolina, has granted authority to the corporations named below to conduct and carry on the business of limited common carriers between the points designated as to each

of the corporations named, and that said corporations have filed with the Corporation Commission of North Carolina tariffs establishing the rate of charges which they are authorized to make for the transportation of commodities between the points named.

The corporations named and the points between which they are authorized to act as limited common carriers, engaged in Intra-state Commerce in North Carolina over a line of steam railroad, are as follows:

Andrews Manufacturing Company, Between Andrews and Old Road Gap, a distance of 8 miles, of thereabouts.

Carr Lumber Company, Between Pisgah Forest and Vanderbilt Boundary, a distance of about 20 miles.

Empire Manufacturing Company, Between Oliver Station to within three miles of Bentonville, about 13 miles.

Enterprise Lumber Company, Between Mount Olive and New Camp, a distance of 18 miles, or thereabouts.

Fishing Creek Timber & Railroad Company, Between Stamper, N. C., and Coffield's Bridge, about 10 miles.

Carolina Southern Railroad, Between Hollister and Vaughan, a distance of 14½ miles, or thereabouts.

Montgomery Lumber Company, Between Spring Hope and Bunn, N. C., a distance of 10 miles or thereabouts.

105 Ocona Luffy Railroad Company, Between Ocona Luffy, N. C., and Smokemont, N. C., about 10 miles.

Rowland Lumber Company, Between Bowdens, N. C., and Warsaw, N. C., toward Newton Grove, a distance of about 20 miles.

Waccamaw Lumber Company, Between Bolton and Makatoka, a distance of about 18 miles.

Weldon Lumber Company, Between Weldon, N. C., and a point near Ringwood, a distance of about 20 miles.

Whiteville Lumber Company, Between Whiteville, N. C., and Buttler, a distance of about 27 miles.

Mill Creek Valley Railroad Between — and — a distance of about — miles.

Suncrest Lumber Co., Sunburst to Canton.

Hilton Railroad & Lugging Co., Hilton Creek to Island Creek, 6 miles.

Done at the office of the Corporation Commission, at Raleigh, on this the — day of May 1922, by the Corporation Commission, through W. T. Lee, its Chairman, and under the seal of the said Commission.

106 *Testimony of C. J. Joseph at Hearing Before Judge Connor.*

C. J. Joseph, Tax Agent of the A. C. L. Railroad, witness for the Plaintiff, examined by Mr. Thomas W. Davis, testifies as follows:

That he had for a great many years been the tax agent of that road, with the duty of checking and looking after all the taxes of that Company and its affiliated lines in Virginia, North and South

Carolina, Georgia, Florida and Alabama. That he was familiar with this litigation and with the Income Tax Laws of North Carolina, that he has to keep up with the stocks and bonds and statistics of the various roads mentioned: that he is familiar with the commercial and financial Chronicle, a financial trade paper, circulated throughout the United States, that collects roads and industrial corporations and their stocks and bonds. The issue of May 27, 1922, of that paper was offered in evidence, and Mr. Davis desired to read into the record the capital stock and bonds of certain industrial corporations reporting to the North Carolina Tax Commission, the Tax Commission showing the capital, but not the bonds issued by them.

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EXHIBIT TO TESTIMONY OF C. J. JOSEPH.

Representative Partial List of Industrial Corporations Doing Business in North Carolina and Reporting to the North Carolina Corporation Commission and Commissioner of Revenue Financed by Bonds and Stocks.

American Agricultural Chemical Company:

Common stock	\$33,322.13
Preferred Stock	28,453.20
First Mortgage bonds	6,252.00
1st Ref. Mortgage s. f. gold bonds, Series "A" ..	30,000.00

American Sugar Refining Company:

Common Stock	45,000.00
Preferred Stock	45,000.00
15 Year Gold Bonds	30,000.00

American Tobacco Company:

Common Stock "A"	40,242.40
Common Stock "B"	49,344.20
Preferred Stock	52,699.70
Gold Bonds	371.85
Gold Bonds & Cons, Tobacco Collateral Trust	
Mortgage Bonds	1,365.30
Series of Gold Notes	10,000.00
8% Dividend Certificates	8,058.50

Dupont, I. E., de Nemours & Company:

Common stock	63,378.50
Debenture Stock	71,243.35
10 Year Gold Bonds	35,000.00

Galena Signal Oil Company:

Common Stock	16,000,000
Preferred Stock	2,000,000
New Preferred Stock	4,000,000
Convertible Debenture	6,000,000
Entire Stock of Subsidiary Companies	2,800,000
Galena Signal Oil of Texas Bonds	2,800,000

General Electric Company:

Common Stock	176,329,100
Debenture for Sprague Stock	2,047,000
Debenture	15,136,500
Debenture Bonds	15,000,000

Kelly Springfield Tire Company:

Common Stock	9,096,002
Preferred Stock	3,137,100
Second Preferred	5,625,200
10 Year s. f. Gold Notes	10,000,000

Morris Company:

1st Mortgage	\$17,626,000
10 Year s. f. Gold Notes	15,000,000
Wm. F. Mosser Co. 10 yr. s. f. notes	3,000,000

Swift & Company:

Common Stock	150,000,000
1st Mortgage s. f. Gold Bonds	28,923,500
Gold Notes	65,000,000

Texas Company:

Stock	164,450,000
3 yr. S. F. Notes	22,772,000

Final Decree.

Filed Nov. 13, 1922.

In the District Court of the United States for the Eastern District of
North Carolina, Raleigh Division.

In Equity.

No. 447.

THE SEABOARD AIR LINE RAILWAY CO.

vs.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, and
JAMES S. MANNING, Attorney General of North Carolina.

Decree.

This is a suit in equity, brought by plaintiff, The Seaboard Air Line Railway Co., a corporation chartered and organized under the laws of the State of Virginia, operating a line of railway in and through the State of North Carolina and the Eastern District thereof, against defendant, A. D. Watts, individually, and as Commissioner of Revenue of North Carolina and James S. Manning, Attorney General of said State, seeking an injunction restraining and enjoining said defendants from taking or causing to be taken any action toward enforcing the filing of a return or the collection of a tax or any part thereof, imposed, or sought to be imposed by the State of North Carolina upon the plaintiff, under or by virtue of the provisions of the Public Laws of North Carolina of 1921, Chapter 34, known as the Revenue Act or the Income Tax Act, as amended by the General Assembly of North Carolina at its Special Session of 1921.

Following the service of process on the defendants and filing answer to the bill, the cause was set down for hearing upon the bill.
110 answer and evidence.

Plaintiff alleges that, by the provisions of Article 5, Section 3 of the Constitution of North Carolina, the General Assembly is authorized to pass laws.

"Taxing, by a uniform rule, all moneys, credits, investments in bonds, stocks, joint-stock Companies, or otherwise, and also real and personal property, according to its true value in money. * * * The General Assembly may also tax trades, professions and incomes. Provided the rate of tax on incomes shall not in any case exceed six per cent, and there shall be allowed the following exemptions, to be deducted from the amount of annual incomes to-wit: For a married man, with a wife living with him, or to a widow or widower having a minor child or children, natural or adopted, not less than \$2,000."

to all other persons not less than \$1,000.00; and there may be allowed other deductions (not including living expenses), so that only net incomes are taxed."

Pursuant to the provisions of the foregoing Art. of the Constitution, the General Assembly, at its Session of 1921, enacted a statute providing for levying, collecting and paying an income tax on individuals and corporations. Chap. 34 Public Laws of North Carolina and known as a part of the Revenue Act of 1921, or, so far as it relates to the Income Tax, as the "Income Tax Act of 1921."

The sections of this Act pertinent to the questions presented for decision by the plaintiff's contention are:

Section 101. Purpose.—

"The general purpose of this Act is to impose a tax for use of the State Government, upon the net income for the calendar year 1921, in excess of exemptions herein set out, collectible in the year 1922 and annually thereafter:

- (a) Of every citizen of the State.
- (b) Of every domestic corporation.
- (c) Of every foreign corporation and of every non resident individual having a business or agency in this State in proportion to the net income of such business or agency.

"Except as otherwise provided in this Act, the purpose is to conform to the definitions of income in the revenue laws of the United States Government and regulations made under its authority in so far as they apply."

"The tax imposed upon the net income of corporations in this Schedule is in addition to the tax imposed under Schedule "C" of this Act."

Section 201. Corporations.—

Every corporation organized under the laws of this State shall pay annually an income tax equivalent to three per cent of the entire net income of such corporation, as herein defined, received by such corporation during the income year; and every foreign corporation doing business in this State shall pay annually an income tax equivalent to three per cent of a proportion of its entire net income, to be determined according to the following rules:

In case of a Company other than Companies mentioned in the next succeeding section, deriving profits principally from the ownership sale or rental of real estate or from the manufacture sale, or use of tangible personal property, such proportion of its entire net income as the fair cash value of its real estate and tangible personal property, in this State, on the date of the close of the fiscal year of such Company in the income year is to be the fair

cash value of its entire real estate and tangible personal property then owned by it, with no deduction on account of incumbrances thereon.

In case of a corporation deriving profits principally from the holding or sale of intangible property such proportion as its gross receipts in this State for the year ended on the date of the close of its fiscal year next preceding is to its gross receipts for such year within and without the State.

“Section 202. Railroads and public service corporations.—

“The basis of ascertaining the net income of every corporation engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the Standard Classification of Accounting of the Interstate Commerce Commission, shall be the ‘net operating income’ of such corporations as shown by their records kept in accordance with that Standard Classification of Accounts, when their business is wholly within this State, and when their business is in part within and in part without this State, including in their gross ‘operating revenues’ within this State the equal mileage proportion within the State of their interstate business and deducting from their gross ‘operating revenues’ the proportionate average of operating expenses in ‘operating ratio’, for their whole business, as shown by the Interstate Commerce Commission Standard Classification of Accounts.

From the net operating income thus ascertained shall be deducted ‘uncollectible revenue,’ and taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes, and the balance shall be deemed to be their net income taxable under this Act.”

The foregoing section relating to the basis of ascertaining the net income of railroads was supplemented by Chapter 35 of the Public Laws of 1921, as follows:

“Sec. 1. That in determining the taxable income of a corporation engaged in the business of operating a railroad under section two hundred and two of the act to raise revenue, in the case of a railroad located entirely within this State, the net operating income shall be increased or decreased to the extent of any credit or debit balance received or paid, as the case may be, on account of car hire, and when any railroad is located partly within and partly without this State, then said net operating income shall be increased or decreased to the extent of an equal mileage proportion within the State of any credit or debit balance received or paid, as the case may be, on account of car hire.”

Section 203 of the Income Tax Act of 1921, as amended by Chapter 35, Public Laws of 1921, is as follows:

“Section 203. Such tax shall first be levied, collected and paid for the year 1922, and with respect to the net income received during the calendar year 1921, and annually thereafter.”

Section 3 of Chapter 34, Public Laws of 1921, provides:

114 "No tax on any property in the State shall be levied for any uses of the State Government. The taxes hereinafter levied in this Act are for the expenses of the State Government, the appropriations to its educational, charitable and penal institutions, pensions for Confederate Soldiers and widows, the interest on the debt of the State, an equalizing fund for public schools, and other specific appropriations made by law, and shall be collected and paid into the general fund of the State Treasurer."

"Section 306. Deductions.—

"In computing net income there shall be allowed as deductions:

"1. All the ordinary and necessary expenses paid during the income year in carrying on any trade or business, including:

"(a) As to individuals, wages of employees for services actually rendered in producing such income.

"(b) As to partnerships, wages of employees and a reasonable allowance for co-partners or members of a firm, for services actually rendered in producing such income, the amount of such salary allowance to be included in the personal return of the co-partner receiving same.

"(c) As to corporations, wages of employees and salaries of officers, if reasonable in amount, for services actually rendered in producing such income.

"2. Rentals or other payments required to be made as a condition of the continued use or possession, for the purposes of the trade of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

"3. All interest paid during the income year on indebtedness except interest on obligations contracted for the purchase of non-taxable securities. Dividends on preferred stock shall not be deducted as interest.

"4. Taxes for the income year, except taxes on income and war profits, and excess profits taxes, inheritance taxes, and taxes assessed for local benefit of a kind tending to increase the value of the property assessed.

"5. Dividends from stock in any corporation the income of which shall have been assessed and the tax on such income paid by the corporation under the provisions of this Act: Provided, that when only part of the income of any corporation shall have been assessed under this Act only a corresponding part of the dividends received therefrom shall be deducted.

"6. Losses sustained during the income year and not compensated by insurance or otherwise, if incurred in any transaction entered into for profit.

"7. Debts ascertained to be worthless and charged off within the income year, if the amount has previously been included in gross income in a return under this Act.

"8. A reasonable allowance for the depreciation and obsolescence of property used in the trade or business; and, in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion: Provided, that in computing the deduction allowed under this paragraph, the basis shall be the cost (including in the case of mines, oil and gas wells, and other natural deposits the cost of development, not otherwise determined) and in the case of property acquired prior to January 1, 1921, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date. The reasonable allowance under this paragraph shall be made under rules and regulations to be prescribed by the Tax Commission. In the case of leases the 116 deductions allowed may be equitably apportioned between the lessor and lessee.

"9. In the case of taxpayers who keep regular books of account upon an accrual basis and in accordance with standard accounting practice, reserves for bad debts and for contingent liabilities, under such rules and restrictions as the Tax Commission may impose. If the Tax Commission shall, at any time, deem the reserve excessive in amount, it may restore such excess to income, either in a subsequent year or as a part of the income of the income year and assess it accordingly.

"10. Contributions or gifts made within the taxable year to corporations or associations operated exclusively for religious, charitable, scientific or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, to an amount not in excess of fifteen per centum of the taxpayer's net income computed without the benefit of this subdivision.

"11. Resident individuals having an established business in another State, or investment in property in another State, may deduct the net income from such business or investment, if such business or investment is in a State that levies a tax upon such net income. The deductions authorized in this subsection shall in no case extend to any part of income of resident individuals from personal services or mortgages, stocks, bonds, securities and deposits.

"12. In the case of a non-resident individual, the deductions allowed in this section shall be allowed only if, and to the extent that they are connected with income arising from sources within the State; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the State shall be determined under rules and regulations prescribed by the State Tax Commission." 117

Complainant is engaged in operating an interstate railroad and keeps its accounts in accordance with the Standard Classification of Accounts prescribed by the Interstate Commerce Commission and is required to pay an income tax under the appropriate part of Section 202 of the Income Tax Act or suffer the penalties prescribed in said Act.

Complainant respectfully shows the Court that the said Act is valid as to complainant for the following reasons:

(a) Article 5, Section 3 of the Constitution of North Carolina authorizes the levy of a tax upon net incomes, and the statutory method prescribed in Section 202 for complainant and like corporations in order to arrive at net income results in the tax being levied on a sum which is not in truth and in fact net income, but includes a part of complainant's operating revenue in this:

Section 202 provides that railway corporations in the class of complainant shall first arrive at gross operating revenue within the State in its interstate business, and from this gross revenue shall deduct the following items:

(1) Proportionate average of operating expenses, as shown by the Interstate Commerce Commission Standard Classification of Accounts.

(2) Uncollectible revenue.

(3) Taxes paid in North Carolina for the income year, other than income taxes and war profits and excess profits taxes.

(4) An equal mileage proportion of car hire.

Plaintiff alleges that defendants, unless restrained by order of this Court, will, pursuant to the provisions of the Statutes in force in the State of North Carolina, levy upon and assess against it the income taxes for the year 1922 and certify such levy and assessment to the officers charged with the enforcement and collection thereof, amounting to a large sum in excess of \$3,000.00. Plaintiff avers that if it is allowed the deductions to which it is entitled it would not have any taxable income because the sum of such deductions is greater than its gross income, and that unless said taxes are paid within the time required by the Statute, plaintiff will be subjected to heavy penalties and that the levy of such taxes will constitute a lien upon its property and thereby a cloud upon its title thereto, and that plaintiff will suffer other and irreparable damage, etc., all of which will appear by reference to the allegations set out in its bill herein. The plaintiff's seeking an injunction, restraining defendants in the discharge of their official duties imposed by the Statute is based upon the allegation that the sections of the Revenue Act of 1921, and especially upon the sections known as the "Income Tax Act" violate the Constitution of the State of North Carolina and of the United States for that and other reasons:

1st. The tax levied as directed by said Statute is not a tax on incomes but is levied upon gross income, or real net operating income and hence is repugnant to the State Constitution and to the Commerce Clause of the Federal Constitution.

2nd. The classification made by Section 202 of the Act as a method of ascertainment of net income for plaintiff and other corporations within the designed class is arbitrary, without reasonable or practical basis and hence is repugnant to the Uniformity Clause Art. 5, Sec. 3 of the State Constitution and the Equal Protection

Clause of the Fourteenth Amendment to the Constitution of the United States.

That it is a violation of the State Constitution for the general property tax to be devoted to local purposes and the various excise, privilege, franchise, license and income taxes to be devoted to State purposes.

That the income tax is invalid because it is levied in addition to property and franchise taxes. That the method of ascertaining the taxable income of plaintiff fixed or prescribed by Section 202 of the Act violates the provisions of Art. 5, Sec. 3 of the State Constitution and of the Fourteenth Amendment to the Federal Constitution, in that such method is not applied to such railroads or other public service corporation which do not operate their properties but have income only from rentals paid them by other companies to whom they lease their entire properties to be operated by the lessees.

It is pertinent, in view of the questions presented by the bills and answers and the prayer for injunctive relief to note the provisions of Section 700-701 of the Income Tax Act as amended by the Act of 1921 creating the office known as Commissioner of Revenue, providing for and prescribing the procedure in applications for review and appeal from assessments and levies of taxes against all persons or corporations having property in, or being liable for, tax in the State.

The Legislature, at its Special Session of 1921, made further provisions for refunding any taxes of any kind which have been through clerical error or misinterpretation or otherwise, collected or paid into

the State Treasury in excess of the amount legally due to the State and directing the State Auditor to issue his warrant for the amount so illegally collected to the person entitled thereto upon certificate of the head of the department through which the taxes were collected or his successor in the performance of the functions of that department, with the approval of the Attorney General and the Treasurer to pay the sum out of any funds in the treasury not otherwise appropriated.

Upon consideration of the bill and answer Exhibits and evidence it is

Adjudged and decreed that plaintiff is not entitled to have the defendants or either of them enjoined and restrained from the performance of the duties imposed upon them by the Statutes of North Carolina relating to the administration, assessing, levying and enforcement or collection of the income tax against plaintiff. The

the bill be dismissed. That defendants recover their cost to be taxed by the Clerk.

This the 7th day of November, 1922.
Wilson, North Carolina.

H. G. CONNOR,
U. S. District Judge

Notice of Appeal.

Filed Nov. 16, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 447.

SEABOARD AIR LINE RAILWAY COMPANY, Plaintiff,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.

Notice of Appeal.

to the defendants in the above-entitled action and Honorable James S. Manning, Attorney General of North Carolina, and Frank Nash, Assistant Attorney General, Solicitors for defendants:

You will please take notice that, on Friday, November 17th, 1922, 10.00 o'clock A. M., or as soon thereafter as counsel may be heard, the above named plaintiff will apply to his Honor, Henry G. Connor, District Judge, at the United States Court Room, Wilmington, N. C., for an order allowing plaintiff to appeal to the Supreme Court of the United States in the above cause and granting a stay of proceedings until the appeal shall have been heard, passed upon and disposed of by the Supreme Court of the United States.

SEABOARD AIR LINE RAILWAY
COMPANY,
By MURRAY ALLEN,
Solicitor.

Service accepted this 16 day of November, 1922.

JAMES S. MANNING,
*Attorney General of North Carolina
and Solicitor for Defendants.*

122

Order Granting Thirty Day Stay.

Filed Nov. 18th, 1922.

In the District Court of the United States for the Eastern District
North Carolina.

In Equity.

No. 447.

SEABOARD AIR LINE RAILWAY COMPANY

vs.

A. D. WATTS, as Commissioner of Revenue of North Carolina, and
Others.

Income Tax Suit.

It is ordered that the defendants shall not proceed to enforce the collection of taxes involved in this litigation for the period of thirty days from the date of this order, to the end that complainant may take such action in the premises as it is advised to.

Dated at Wilmington, North Carolina this the 17th day of
November, 1922.

H. G. CONNOR,
U. S. Judge.

123

Assignments of Error.

Filed Nov. 27, 1922.

In the District Court of the United States for the Eastern District
North Carolina.

In Equity.

No. 447.

SEABOARD AIR LINE RAILWAY COMPANY, Plaintiff,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.
Defendants.

Now comes the plaintiff in the above entitled cause and, in connection with its petition for appeal from the decree entered November 15th, 1922, denying the application for a permanent injunction, files the following assignments of error:

The Court erred:

1. In decreeing that, upon consideration of the bill and answer, exhibits and evidence, plaintiff is not entitled to have the defendants or either of them enjoined and restrained from the performances of the duties imposed upon them by the statutes of North Carolina relating to the administration, assessing, levying and enforcement or collection of the income tax against the plaintiff.

2. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because said act is in violation of the Constitution of North Carolina and the Constitution of the United States, creates a discrimination against plaintiff and other railroad companies or similar character in favor of other corporations and individuals in that the said act in order to ascertain the taxable income allows other corporations and individuals certain deductions, many of which said deductions are not allowed to plaintiff and other railroad corporations of similar character.

3. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because, under the provisions of the Income Tax Act of 1921, and particularly Section 202, Section 300, and Section 306, all corporations which are required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, are required to pay a tax on their net income, which is defined by Section 300 as "the gross income of a taxpayer, less the deductions allowed by this act," whereas plaintiff and other railroads and public service corporations which are required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, are required to pay a tax on their net income, which is defined by Section 300 as "the gross income of a taxpayer, less the deductions allowed by this act," whereas plaintiff and other railroads and public service corporations which are required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, are not allowed the deductions set forth in the said act, except "uncollectible revenue" and taxes paid in the State for the income year other than income taxes, ware profits and excess profits taxes, and certain deductions for car hire, and plaintiff and other railroad companies and public service corporations of similar character referred to in Section 202 of the Income Tax Act of 1921 are denied large deductions which are granted other corporations, individuals and railroads not included in the provisions of Section 202, and particularly the deduction of interest paid during the income year, which results in discrimination against the plaintiff, in violation of the Constitution of North Carolina, and denies the plaintiff the equal protection of the law and deprives it of its

property without due process of law in contravention of the Fourteenth Amendment of the Constitution of the United States.

4. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax
125 attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because said act does not operate equally and uniformly upon all taxpayers in similar circumstances, and that the plaintiff and other railroads and public service corporations, which are required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, have been arbitrarily selected and taxed upon a more burdensome basis and one that is different from that applied to corporations in general and to other corporations engaged in business similar to that of plaintiff, in violation of the Constitution of North Carolina and plaintiff is thereby denied the equal protection of the law and is deprived of its property without due process of law in contravention of the Fourteenth Amendment of the Constitution of the United States.

5. In failing to hold that the plaintiff is entitled to an injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because said tax is not levied by a uniform rule as required by the Constitution of North Carolina, Article 5, Section 3, and the lack of uniformity works greatly to the detriment of plaintiff, in violation of said Article 5, Section 3, of the Constitution of North Carolina, and denies the plaintiff the equal protection of the law and deprives it of its property without due process of law, in contravention of the Fourteenth Amendment of the Constitution of the United States.

6. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because the classification of taxpayers for the purpose of fixing the income on which the tax shall be paid as made by the said Income Tax Act of 1921 is not based upon any reasonable ground, but is a mere arbitrary selection so far as plaintiff and railroad companies of similar character are concerned and so far as the corporations set forth in Section 202 are concerned, and was made for the purpose and has the result of imposing upon such railroad companies and corporations, including
126 plaintiff, and unjust burden of taxation, in violation of the Constitution of North Carolina and denies the plaintiff the equal protection of the law and deprives it of its property without due process of law, in contravention of the Fourteenth Amendment of the Constitution of the United States.

7. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void, because the

method of fixing plaintiff's taxable income as provided by Section 202 of the said Income Tax Act of 1921 violates the Constitution of North Carolina and the Constitution of the United States because it does not apply to railroads and public service corporations which derive their income from sources other than the operation of their property, which results in a lack of uniformity in the application of the income tax and in discrimination against plaintiff, and therein denies the plaintiff the equal protection of the law and deprives it of its property without due process of law, in contravention of the Fourteenth Amendment of the Constitution of the United States.

8. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void, because the authority of the Legislature of North Carolina to tax incomes is derived from Section 3, Article 5. of the Constitution of North Carolina, and said section provides that only net incomes may be taxed, and in attempting to tax the "operating revenues" of plaintiff, the said act violates the Constitution of North Carolina and denies the plaintiff the equal protection of the law and deprives it of its property without due process of law, in contravention of the Fourteenth Amendment of the Constitution of the United States.

9. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because said act is violative of Article 5, Section 3, of the Constitution of North Carolina, for that it does not levy upon railroads and other public service corporations named in said Section 202, a tax on net income, but levies a tax upon operating revenue derived from interstate and intrastate commerce, and does not permit the deductions necessary and incidental to the business of plaintiff and expended by it from said income in order to determine net income, and is in violation of the Interstate Commerce Clause, (Section 8, Article 1) of the Constitution of the United States, in that it permits a tax as an income tax to be placed on gross income derived from interstate commerce, thereby burdening interstate commerce.

10. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because said act violates the Transportation Act of Congress and the Interstate Commerce Act, in that it seeks to prescribe a method of accounting by this interstate carrier, when said Acts of Congress have delegated the power to prescribe said accounting to the Interstate Commerce Commission and the said Commission has prescribed and directed that this plaintiff and other interstate carriers keep their accounts in accordance with the methods so prescribed by it.

11. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because the

State of North Carolina, by its tax laws, permits the counties,
128 cities, towns, townships and special taxing districts to levy taxes on the assessed value of plaintiff's property known as an ad valorem tax, which is based upon the whole property of plaintiff, tangible, and to this the tax laws of the State add a so-called franchise tax of one-tenth of one per cent on the same assessed value, and by the statutes hereinbefore referred to, the Legislature of North Carolina has levied and unless restrained the defendants in this action will undertake to collect an additional tax characterized as an income tax of three per cent on plaintiff's net operating revenue, including revenue derived from interstate commerce, and plaintiff avers that this system of pyramiding taxes and the entire scheme of taxation amounts to a regulation of commerce between the States, because necessarily a tax of one-tenth of one per cent upon the tangible and intangible property of this plaintiff and a tax of three per cent upon its net operating revenue, including revenue derived from interstate commerce, are taxes upon interstate commerce the property, tangible and intangible, having already been taxed at its full value and plaintiff shows that this scheme of taxation levies a tax and burden upon the interstate commerce of plaintiff and violates the Commerce Clause of the Constitution of the United States, Section 8 of Article 1.

12. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because the penalties imposed for failure to comply with the Income Tax Act enacted by the Legislature of North Carolina are so excessive as to be violative of plaintiff's rights under the Constitution of the United States.

13. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because
129 the plaintiff has no adequate remedy at law.

14. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void for that the levy of the income tax casts a cloud upon plaintiff's title.

MURRAY ALLEN,
Solicitor for Plaintiff.

Stipulation of Counsel as to Record.

Filed Dec. 5, 1922.

In the District Court of the United States for the Eastern District
of North Carolina.

In Equity.

No. 447.

SEABOARD AIR LINE RAILWAY COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.*Stipulation of Counsel as to Record.*It is stipulated and agreed by and between the parties to the above
entitled cause:That the Clerk, in making up the transcript of record on this ap-
peal from the decree of the District Court shall include:

Bill of complaint and exhibits.

Application for interlocutory injunction.

Order on application for interlocutory injunction.

Notice of hearing on application for interlocutory injunction.

Answer.

Affidavit of J. H. Bridgers with exhibits.

Affidavit of Nathan O'Berry.

Affidavit of C. D. Bradham.

Affidavit of A. R. Turnbull.

Affidavit of J. C. Nelms.

Affidavit of J. C. Nelms.

Affidavit of J. C. Nelms.

Affidavit of F. C. Harding.

Affidavit of W. H. McKenzie.

Affidavit of W. L. Stanly.

Affidavit of M. S. Hawkins.

Affidavit of E. H. Kemper.

Affidavit of O. S. Thompson.

Affidavit of A. J. Maxwell.

Affidavit of R. O. Self.

Testimony and exhibits.

Certificate of Corporation Commission as to certain lumber corpo-
rations, and others licensed as common carriers and engaged in in-
terstate commerce in North Carolina.

Notice of appeal.

Petition for appeal.

Assignments of error.

Order allowing appeal and granting supersedeas and stay Bond and Citation.

Decree.

Stipulation of counsel.

It is further stipulated that the Clerk may use in preparing the record on appeal printed copies of all such pleadings, documents, affidavits, etc., as may be furnished by the parties hereto.

MURRAY ALLEN,
Solicitor for Complainant.
GEO. H. BROWN,
Of Counsel for Defendants.

131 *Memorandum of Original Papers Certified Separately.*

Petition for Appeal filed November 27th, 1922.

Appeal allowed November 27, 1922.

Appeal Bond dated Dec. 7, 1922; penalty, \$1,000.00; Obligors Seaboard Air Line Railway Company and Royal Indemnity Company: Conditioned for damages and costs.

Citation dated Nov. 27, 1922; service accepted by George H. Brown, of Counsel for Defendants, Nov. 27th, 1922.

132

Order to Transmit Record.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

#447.

SEABOARD AIR LINE RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue, et als.

And thereupon it is ordered by the Court here that a transcript of the record and proceedings in said suit be transmitted to the United States Supreme Court at Washington, D. C., and the same be transmitted accordingly.

S. A. ASHE,
Clerk United States District Court.

Clerk's Certificate.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 447.

SEABOARD AIR LINE RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue, et als

I, S. A. Ashe, Clerk, United States District Court, for the Eastern District of North Carolina, do hereby certify that the foregoing pages present a full, true and correct copy of the proceedings had and orders entered in that certain suit in equity pending in said Court, wherein Seaboard Air Line Railway Company is complainant and A. D. Watts, Commissioner of Revenue of North Carolina, and others, are Defendants.

In testimony whereof, I have hereunto set my hand and affixed the seal of the said District Court at the Courthouse in Raleigh, State of North Carolina, this 16 day of December, 1922.

[Seal United States District Court, Eastern Dist. of N. C. at Raleigh.]

S. A. ASHE,

Clerk United States District Court.

24 & 135 In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 447.

SEABOARD AIR LINE RAILWAY COMPANY, Plaintiff.

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et als.,
Defendants.

Petition for Appeal and Stay.

to the Honorable H. G. Connor, District Judge of the United States for the Eastern District of North Carolina:

The Seaboard Air Line Railway Company, the above named plaintiff, feeling aggrieved by the order of the Court entered in the above entitled cause on the 13th day of November, 1922, refusing and deny-

ing the injunction applied for in this cause restraining the defendants from collecting the income tax assessed against the plaintiff, hereby appeals to the Supreme Court of the United States from the said order upon the grounds set forth in the assignments of error filed herewith, and plaintiff prays that its appeal be allowed and that citation be issued as provided by law and that a transcript of the record, proceedings and documents, upon which said appeal is based, duly authenticated, be sent to the Supreme Court of the United States under the rules of such Court in such cases made and provided.

And plaintiff further prays that the Court enter an order staying the collection of the said income tax and staying further proceedings by the defendants until the appeal herein prayed for shall have been heard, passed upon and disposed of by the Supreme Court of the United States.

SEABOARD AIR LINE RAILWAY
COMPANY,
By MURRAY ALLEN,
Solicitor.

136 [Endorsed:] No. 447. Eq. Seaboard Air Line Railway Company, Plaintiff, vs. A. D. Watts, Commissioner of Revenue of North Carolina, et als., Defendants. Petition for Appeal and Stay. Murray Allen, Attorney at Law, 709-711 Citizens National Bank Building. I certify that the within is entered and filed this day, Nov. 27, 1922. S. A. Ashe, Clerk.

137 & 138 In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 447.

SEABOARD AIR LINE RAILWAY COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.
Defendants.

Order Allowing Appeal and Granting Supersedeas and Stay.

This cause coming on to be heard upon the application of complainant, Seaboard Air Line Railway Company, for an appeal to the Supreme Court of the United States, and for a supersedeas and order staying and restraining the collection of the income tax involved in this suit and alleged to be illegal in the complaint filed herein, until the determination of the appeal in this cause now pending in the Supreme Court of the United States, and complainant being represented by Murray Allen, its attorney, and the defendants by their attorneys, Frank Nash, Assistant Attorney General of North Carolina

and George H. Brown, the appeal prayed for is hereby granted, Appeal Bond in the sum of \$1,000.00 to be filed.

And the Court being of the opinion that the status quo between the parties should be preserved pending such determination of appeal by the complainant to the Supreme Court of the United States:

It is, therefore, decreed and adjudged that defendants, their agents, servants and employees and each of them be and are hereby restrained from collecting or attempting to collect from complainant the income tax which is the subject matter of this suit, pending the determination of the appeal by the complainant in this cause now pending in the United States Supreme Court.

It is further ordered and decree that complainant do give bond, with good and sufficient surety, in the sum of \$10,000.00, to be approved by the Judge of the United States Court, or the Clerk of said Court, conditioned to pay to said defendants all of such income tax that may finally be determined in this cause to be legally due and payable by the complainant to the defendants.

Dated this 27th day of November, 1922.

H. G. CONNOR,

District Judge Eastern District of North Carolina.

139 [Endorsed:] (J.) No. 477. Eq. Seaboard Air Line Railway Co. vs. A. D. Watts, Commissioner of Revenue, et al. Order Allowing Appeal & Granting Supersedeas & Stay under \$10,000 Bond. I certify that the within is entered and filed this day, Nov. 27, 1922. S. A. Ashe, Clerk.

140 In the District Court of the United States for the Eastern District of North Carolina.

SEABOARD AIR LINE RAILWAY COMPANY

vs.

A. D. WATTS et als.

Know all men by these presents: That Seaboard Air Line Railway Company, as principal, and Royal Indemnity Company, as surety, acknowledge themselves indebted to the defendants, A. D. Watts, Commissioner of Revenue of North Carolina, Benjamin R. Lacy, State Treasurer of North Carolina, Baxter Durham, State Auditor of North Carolina, and James S. Manning, Attorney General of North Carolina, in the above entitled cause in the sum of One Thousand (\$1,000.00) Dollars, to the payment of which we bind ourselves, our successors and assigns.

In witness whereof, Seaboard Air Line Railway Company, principal, has caused these presents to be executed by M. J. Caples, one of its vice-presidents, its corporate seal to be hereto affixed, and attested by T. W. Mathews, one of its assistant secretaries, and Royal Indemnity Company, the surety, has caused these presents to be executed by S. E. Haynes, its Attorney in Fact, duly appointed and

authorized to execute surety bonds, and its corporate seal to be hereto affixed.

The condition of the foregoing bond is such that:

Whereas, Seaboard Air Line Railway Company, the above named plaintiff, instituted a suit in the United States District Court for the Eastern District of North Carolina against A. D. Watts, and other defendants named in said bill, in which said cause a permanent injunction was asked to be granted against the defendants, enjoining the collection of the income tax claimed to be due the State of North Carolina as set out in said bill upon the grounds as set forth in said bill; and,

Whereas, upon the hearing of said application for a permanent injunction, the prayer of the plaintiff was denied and the bill dismissed; and,

Whereas, the plaintiff has obtained an appeal to the Supreme Court of the United States and a citation has been issued to the defendants citing and admonishing them to be and appear in the Supreme Court of the United States on December 27th, 1922:

Now, the condition of the above obligation is such that, if the said Seaboard Air Line Railway Company shall prosecute its appeal to effect and answer all damages and costs if it fail to make its plea good, then the above obligation to be void; else to remain in full force and effect.

In witness whereof, Seaboard Air Line Railway Company, principal, has caused these presents to be executed by M. J. Caples, one of its vice-presidents, its corporate seal to be hereto affixed, and attested by T. W. Mathews, one of its assistant secretaries, and Royal Indemnity Company, surety, has caused these presents to be executed by S. E. Haynes its Attorney in Fact, thereunto duly authorized and empowered so to do, and its corporate seal to be hereto affixed, this the 7th day of December, 1922.

SEABOARD AIR LINE RAILWAY
COMPANY,

By M. J. CAPLES,
Vice-President.

Attest:

[Seal of the Seaboard Air Line Railway Company.]

T. W. MATHEWS,
Assistant Secretary.

[Seal of the Royal Indemnity Company.]

ROYAL INDEMNITY COMPANY,
By S. E. HAYNES,
Attorney in Fact.

Approved:

H. G. CONNOR,
*Judge of the United States
District Court for the Eastern
District of North Carolina.*

143 [Endorsed:] #447. Eq. Seaboard Air Line Railway Company vs. A. D. Wats et als. Appeal Bond. Murray Allen, Attorney at Law, 709-711 Citizens National Bank Building, Raleigh, N. C. I certify that the within is entered and filed this day, Dec. 13, 1922. S. A. Ashe, Clerk.

144 In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 447.

SEABOARD AIR LINE RAILWAY COMPANY, Plaintiff,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina; BENJAMIN R. LACY, State Treasurer of North Carolina; Baxter Durham, State Auditor of North Carolina, and James S. Manning, Attorney General of North Carolina, Defendants.

The United States of America to A. D. Watts, Commissioner of Revenue of North Carolina; Benjamin R. Lacy, State Treasurer of North Carolina; Baxter Durham, State Auditor of North Carolina, and James S. Manning, Attorney General of North Carolina, Greeting:

Whereas, Seaboard Air Line Railway Company has lately appealed to the Supreme Court of the United States, from a decree lately rendered in the District Court of the United States for the Eastern District of North Carolina, made in favor of you, the said Seaboard Air Line Railway Company, having filed the security required by law, you are therefore hereby cited to appear before the said Supreme Court of the United States, at the City of Washington on the 27th day of December, next, to do and receive what may appertain to justice to be done in the premises.

Given under my hand at the City of Raleigh in the Fourth Circuit, this the 27th day of November, in the year of our Lord, One Thousand Nine Hundred and Twenty-two.

H. G. CONNOR,

Judge of the District Court of the United States for the Eastern District of North Carolina.

I certify that the within is entered and filed this day Nov. 27, 1922.

S. A. ASHE,
Clerk.

Service accepted this November 27th, 1922.

GEO. H. BROWN,
Of Counsel for Defendants.

145 [Endorsed:] #447. Eq. Seaboard Air Line Railway Company vs. A. D. Watts et al. Citation & Acceptance of Service. I certify that the within is entered and filed this day, Nov. 27, 1922. S. A. Ashe, Clerk.

Endorsed on cover: File No. 29,294. E. North Carolina D. C. U. S. Term No. 744. Seaboard Air Line Railway Company, appellant, vs. A. D. Watts and A. D. Watts, as Commissioner of Revenue of the State of North Carolina, et al. Filed December 18th, 1922. File No. 29,294.

(8267)

A.

For
JAN

FILED
APR 7 1923

WM. R. STANSBURY
CLERK

IN THE
SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1922

No. 744

SEABOARD AIR LINE RAILWAY COMPANY,

Appellant.

vs.

A. D. WATTS, COMMISSIONER OF REVENUE OF
NORTH CAROLINA; BENJAMIN R. LACY, STATE
TREASURER OF NORTH CAROLINA; BAXTER
DURHAM, STATE AUDITOR OF NORTH CARO-
LINA, AND JAMES S. MANNING, ATTORNEY
GENERAL OF NORTH CAROLINA,

Appellees.

BRIEF ON BEHALF OF APPELLANT

MURRAY ALLEN,

Counsel for Plaintiff.

FORNEY JOHNSTON,

JAMES F. WRIGHT,

Of Counsel.

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IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1922.

No. 744

SEABOARD AIR LINE RAILWAY COMPANY,

Appellant.

Against

A. D. WATTS, Commissioner of Revenue of North Carolina;
BENJAMIN R. LACY, State Treasurer of North Carolina;
BAXTER DURHAM, State Auditor of North Carolina,
and JAMES S. MANNING, Attorney General of North
Carolina,

Appellees.

BRIEF ON BEHALF OF APPELLANT.

ASSIGNMENTS OF ERROR.

The assignments of error will be found in full in this brief as Appendix A. Succinctly stated, these assignments of error and the questions presented by this appeal are as follows:

1. The Constitution of North Carolina authorizes the Legislature to tax only net incomes, and the Income Tax Act violates the Constitution in levying a tax upon plaintiff's operating revenue.
2. The Income Tax levied on carriers engaged in interstate commerce by Section 202 of the Income Tax Act of 1921 is a burden on interstate commerce and violates the Commerce Clause of the Constitution of the United States.
3. The Income Tax Act of 1921 creates an unlawful discrimination against plaintiff in the attempted classification of railroads and other public service corporations in violation

of the Constitution of North Carolina and the Constitution of the United States.

4. The scheme of taxation by which the State government is supported by taxes other than *ad valorem* tax on property violates the Constitution of North Carolina.

5. The Court erred in denying the injunction and dismissing the bill.

STATEMENT OF THE CASE.

This action is brought to enjoin the collection of a tax levied on plaintiff by the Income Tax Act, enacted by the Legislature of North Carolina at the Session of 1921, upon the grounds, as more fully set out herein, that such act violates the Constitution of North Carolina and the Constitution of the United States.

The provisions of the Constitution of North Carolina, Article 5, Section 3, authorizing the levy of an income tax are as follows:

"Laws shall be passed taxing, by a uniform rule, all moneys, credits, investments in bonds, stock, joint-stock companies, or otherwise; and, also, all real and personal property, according to its true value in money: *Provided*, notes, mortgages, and all other evidence of indebtedness given in good faith for the purchase price of a home, when said purchase price does not exceed three thousand dollars, and said notes, mortgages, and other evidence of indebtedness shall be made to run for not less than five nor more than twenty years, shall be exempt from taxation of every kind: *Provided*, that the interest carried by such notes and mortgages shall not exceed five and one-half per cent. The General Assembly may also tax trades, professions, franchises, and incomes: *Provided*, the rate of tax on incomes shall not in any way exceed six per cent (6%), and there shall be allowed the following exemptions, to be deducted from the amount of annual incomes,

to-wit: for a married man with a wife living with him, or to a widow or widower having a minor child or children, natural or adopted, not less than \$2,000; to all other persons less than \$1,000, and there may be allowed other deductions (not including living expenses) so that only net incomes are taxed."

The Legislature of North Carolina, at its regular session of 1921, purporting to act under the authority of the provisions of the constitution above quoted, enacted a law providing for the levying, collecting and paying of an income tax on individuals and corporations, the said law forming a part of the Revenue Act of 1921, being Chapter 34 of the Public Laws of North Carolina of 1921. It is provided by Section 100 of the Revenue Act that the income tax schedule should be known and cited as the Income Tax Act of 1921, and the said act will be so referred to in this brief.

Section 101 of this act as amended by the General Assembly of North Carolina, Special Session of 1921, is as follows:

"Sec. 101. Purpose. The general purpose of this act is to impose a tax, for the use of the State Government, upon the net income for the calendar year 1921, in excess of exemptions herein set out, collectible in the year 1922, and annually thereafter:

- (a) Of every citizen of the State.
- (b) Of every domestic corporation.
- (c) Of every foreign corporation and of every nonresident individual having a business or agency in this State, in proportion to the net income of such business or agency.

Except as otherwise provided in this act the purpose is to conform to the definitions of income in the revenue laws of the United States Government and regulations made under its authority, in so far as they apply.

The tax imposed upon the net income of corporations in this schedule is in addition to the tax imposed under Schedule C of this Act."

Section 201, as amended by the General Assembly of North Carolina, Special Session of 1921, provides:

"Sec. 201. Corporations. Every corporation organized under the laws of this State shall pay annually an income tax equivalent to three per cent of the entire net income of such corporation, as herein defined, received by such corporation during the coming year; and every foreign corporation doing business in this State shall pay annually an income tax equivalent to three percent of a proportion of its entire net income, to be determined according to the following rules:

In case of a company other than companies mentioned in the next succeeding section, deriving profits principally from the ownership, sale, or rental of real estate or from the manufacture, sale, or use of tangible personal property, such proportion of its entire net income as the fair cash value of its real estate and tangible personal property in this State on the date of the close of the fiscal year of such company in the income year is to the fair cash value of its entire real estate and tangible personal property then owned by it, with no deduction on account of incumbrances thereon.

In case of a corporation deriving profits principally from the holding or sale of intangible property, such proportion as its gross receipts in this State for the year ended on the date of the close of its fiscal year next preceding is to its gross receipts for such year within and without the State."

Section 202 of the Income Tax Act of 1921, under which the income tax is levied on plaintiff is as follows:

"Sec. 202. Railroads and public service corporations. The basis of ascertaining the net income of every corporation engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service, when such company

is required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, shall be the 'net operating income' of such corporations as shown by their records kept in accordance with that standard classification of accounts, when their business is wholly within this State, and when their business is in part within and in part without the State their net income within this State shall be ascertained by taking their gross 'operating revenues' within this State, including in their gross 'operating revenues' within this State the equal mileage proportion within this State of their interstate business and deducting from their gross 'operating revenues' the proportionate average of 'operating expenses' or 'operating ratio,' for their whole business, as shown by the Interstate Commerce Commission standard classification of accounts. From the net operating income thus ascertained shall be deducted 'uncollectible revenues', and taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes, and the balance shall be deemed to be their net income taxable under this Act."

In addition to the deductions allowed the corporations referred to in Section 202, railroads are permitted to deduct certain items of car hire as provided by Chapter 35, Public Laws of 1921.

The deductions allowed corporations other than those referred to in Section 202 are shown on the Corporation Income Tax Return issued by the State Department of Revenue, (Printed Record, page 28,) and based upon Section 306 of the Income Tax Act, as follows:

1. All the ordinary and necessary expenses paid during the income year in carrying on any trade or business.
2. Reasonable compensation of officers.
3. Rentals or other payments required to be made as a condition of the continued use or possession, for the pur-

pose of the trade of property to which the taxpayer has not taken, or is not taking title, or in which he has no equity.

4. All interest paid during the income year on indebtedness, except interest on obligations contracted for the purchase of nontaxable securities. Dividends on preferred stock shall not be deducted as interest.

5. Taxes for the income year, except taxes on income and war profits and excess profits taxes, inheritance taxes, and taxes assessed for local benefit of a kind tending to increase the value of the property assessed.

6. Dividends from stock in any corporation the income from which shall have been assessed and the tax on such income paid by the corporation under the provisions of this act: *Provided*, that when only part of the income of any corporation shall have been assessed under this act only a corresponding part of the dividends received therefrom shall be deducted.

7. Losses sustained during the income year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit.

8. Debts ascertained to be worthless and charged off within the taxable year if the amount has previously been included in gross income in a return under this act.

9. A reasonable allowance for depreciation and obsolescence (if any) and depletion (if any).

10. Reserve for bad debts, in case of taxpayers who keep regular books of account.

11. Deduct from net taxable income contributions or gifts made within the taxable year to corporations or associations, enumerated in Section 306, Article 3, not exceeding 15 per cent of net income.

The deductions allowed individuals are set out in Section 306 of the Income Tax Act, and are practically the same deductions allowed corporations.

It appears from the affidavit of H. W. MacKenzie, General Auditor of Seaboard Air Line Railway Company (Printed Record, page 34), and Exhibits A and B, (Printed Record, pages 35 and 37), that the plaintiff will be required under the North Carolina Income Tax Act, if valid, to pay an income tax for the year 1921 of \$13,133.09, whereas the statement of net income for the year 1921, according to the classification of accounts prescribed by the Interstate Commerce Commission shows that plaintiff sustained a net loss in 1921 in the State on North Carolina of \$254,290.22.

ARGUMENT.

I

THE CONSTITUTION OF NORTH CAROLINA AUTHORIZES THE LEGISLATURE TO TAX ONLY NET INCOMES, AND THE INCOME TAX ACT VIOLATES THE CONSTITUTION IN LEVYING A TAX UPON PLAINTIFF'S OPERATING REVENUE.

Article 5, Section 3, of the Constitution of North Carolina, as amended, provides that the general assembly may tax incomes and after providing for certain exemptions to individuals, it concludes with this language: "*So that only net incomes are taxed.*"

We submit that this section of the Constitution restricts the authority of the general assembly to the taxation of *net incomes*. In the absence of the concluding words, this section, under the usual rules for the construction of statutes and constructions would be limited to net incomes, because the definite and well understood and the ordinary and every-day meaning of the word "income" is the profit or gain derived from capital or from labor or from both, and it is so defined in *Stratton's Independence v. Howbert*, 231 U. S., 399, and in *Eisner v. Macomber*, 252 U. S., 189.

In 26 Ruling Case Law, 140, the writer of the article on Taxation says:

"The word income appears to have been used in the reported cases as meaning gross receipts, net earnings, gains or profits, depending on the context. In constitutional and statutory provisions in regard to taxation, however, income appears to be uniformly construed as meaning net income, as opposed to gross receipts, which are also in some cases a measure of taxation. Income means the balance of gain over loss and where there is no such balance of gain there is no income which is capable of being assessed. *The gross returns which an owner receives from his property do not denote his income, which means what he has for himself, what he can spend after satisfying all just outgoings in respect to the property which yields the return.*" (Italics added).

The General Assembly of 1921 recognized the constitutional limitation of its authority and in Section 101 of the Income Tax Act declared the general purpose of the act to be to impose a tax upon the *net income*. But while the limitation was recognized in this section, it was disregarded when Section 202 was so drawn as to tax the net operating revenue of the corporations referred to therein, and not the net income, the purpose being to fix the taxable income of such corporations at a figure which would of necessity exceed their net income.

The Interstate Commerce Commission in a system of uniform accounting adopted under the authority of the Interstate Commerce Act permits the following deductions in arriving at the true net income of railroads in addition to the deductions set forth in Section 202:

- Joint Facility Rents;
- Rent for Leased Roads;
- Miscellaneous Tax Accruals;
- Separately Operated Properties—Loss;
- Interest on Funded Debt;
- Interest on Unfunded Debt;
- Amortization of Discount on Funded Debts;
- Maintenance of Investment Organization;

Income Transferred to other Companies;
Miscellaneous Income Charges.

Manifestly these deductions must be permitted before it can be determined what amount the railroad has for itself and what it can spend after satisfying all just outgoings in respect of the property which yields the revenue. Revenue cannot be translated into income in the sense the word is used in the Constitution of North Carolina and as it is defined by the Supreme Court of the United States in *Stratton's Independence v. Howbert*, 231 U. S., 399, until the items of expense and loss in producing the revenue have been deducted. The numerous deductions found by the Interstate Commerce Commission to be necessary before net income can be determined, which are not permitted by the Income Tax Act of North Carolina, demonstrate, we submit, that this act necessarily results in levying the income tax of plaintiff on a sum which is much larger than its net income.

II

THE INCOME TAX LEVIED ON CARRIERS ENGAGED IN INTERSTATE COMMERCE BY SECTION 202 OF THE INCOME TAX ACT OF 1921 IS A BURDEN ON INTERSTATE COMMERCE AND VIOLATES THE COMMERCE CLAUSE OF THE CONSTITUTION OF THE UNITED STATES.

The tax imposed by the Income Tax Act of 1921 is a burden on interstate commerce in that it is levied upon the operating revenue of a carrier engaged in interstate commerce and expressly requires that the revenue derived from that part of the carrier's business, which is within the state, shall be included in the sum taxed as "net income." The act does not tax the "net income" derived by a railroad company from its intrastate and interstate business, but it taxes such part of the operating revenue derived from its interstate business as is represented by the proportion of the mileage in North Carolina to the total mileage of the system. This inevitably taxes revenue

from interstate commerce as distinguished from "net income," and the amount of the tax to be paid "necessarily varies in proportion to the volume of that commerce, and hence amounts to a direct burden on it."

Crew Levick Co. v. Pennsylvania, 245 U. S., 292.

"It is well settled that a state cannot lay a tax upon interstate commerce in any form, whether by way of duties laid on the transportation of the subjects of that commerce *or the receipts derived from that transportation*, or on the occupation or business of carrying on, for the reason that such taxation is a burden on that commerce, and amounts to a regulation of it, which belongs to congress. (Italics added).

Lyng v. Michigan, 135 U. S., 161;

LeLoup v. Port of Mobile, 127 U. S., 640;

Telegraph Co. v. State Board, 132 U. S., 472;

McCall v. California, 136 U. S., 104;

Railroad Co. v. Pennsylvania 136 U. S., 114.

In 12 Corpus Juris, page 96, note 98, will be found an exhaustive list of the decisions of the United States Supreme Court and the state courts in support of this proposition. See also *Bain v. Railroad*, 105 N. C., 363, in which Chief Justice Merrimon discusses the reason for the rule.

In *Kansas City F. S. & R. M. Co. v. Botkin*, 240 U. S., 227, it is said:

"It must be assumed, in accordance with repeated decisions, that the state cannot lay a tax on interstate commerce 'in any form,' by imposing it either upon the business which constitutes such commerce or the privilege of engaging in it, or upon the receipts as such derived from it. And, further, in determining whether a tax has such a direct relation to interstate commerce as to be an exercise of power prohibited by the commerce clause, our decision must regard the substance of the exaction—its operation and effect as enforced,—and cannot depend upon the

manner in which the taxing scheme has been characterized."

The concluding paragraph of the opinion of Mr. Justice Pitney in *United States Glue Company v. Town of Oak Creek*, 247 U. S., 321, in which the levy and assessment of a general income tax upon the net income of a corporation derived from transactions in interstate commerce is upheld, contains a statement of the essential elements of a valid income tax on interstate commerce:

"And so we hold that the Wisconsin income tax law, as applied to the plaintiff in the case before us, cannot be deemed to be so direct a burden upon the plaintiff's interstate business as to amount to an unconstitutional interference with or regulation of commerce among the states. *It was measured not by gross receipts, but by the net proceeds from this part of plaintiff's business*, along with a like imposition upon its income derived from other sources, and in the same way that other corporations doing business within the state are taxed upon that proportion of their income derived from business transacted and property located within the state, whatever the nature of their business." (Italics added)

In the same case it is said:

"It is settled that a state may not directly burden interstate commerce, either by taxation or otherwise. But a tax that only indirectly affects the profits or returns from such commerce is not within the rule."

And after referring to the cases of *Crew Levick Co. v. Pennsylvania*, 245 U. S., 292 and *Peck & Co. v. Lowe, Collector*, 247 U. S., 165, as illustrating the correct line of distinction between an income tax which directly burdens interstate commerce and one which does not, Mr. Justice Pitney says:

"This distinction between a direct and an indirect bur-

den by way of tax or duty was developed, and it was shown that an income tax laid generally on net incomes, not on income from exportation because of its source or in the way of discrimination, but just as it was laid on other income, and effecting only the net receipts from exportation after all expenses were paid and losses adjusted and the recipient of the income was free to use it as he chose, was only an indirect burden."

In *Crew Levick Co. v. Pennsylvania*, 245 U. S., 292, the court in another opinion by Mr. Justice Pitney, holds that an income tax on wholesale and retail dealers in merchandise, the amount of which is based upon the volume of business transacted, in so far as it is measured by the gross receipts from merchandise shipped to foreign countries, on orders taken there or sent direct to the dealer, constitutes a direct burden on foreign commerce. In the opinion it is said:

"In *Postal Telegraph Cable Co. v. Adams*, 155 U. S., 688, the court, again speaking by Mr. Chief Justice Fuller, said 'It is settled that where, by way of duties laid on the transportation of the subjects of interstate commerce, or on the receipts derived therefrom, or on the occupation or business of carrying it on, a tax is levied by a state on interstate commerce, such taxation amounts to a regulation of such commerce and cannot be sustained.' *The tax now under consideration, so far as it is challenged, fully responds to these tests. It bears no semblance of a property tax, or a franchise tax in the proper sense; nor is it an occupation tax, except as it is imposed on the very carrying on of the business of exporting merchandise. It operates to lay a direct burden upon every transaction in commerce by withholding, for the use of the state, a part of every dollar received in such transactions. That it applies to internal as well as foreign commerce cannot save it; for, as was said in case of the State Freight Tax, 15 Wall. 232: 'The state may tax its internal commerce, but if an act*

to tax interstate or foreign commerce is unconstitutional it is not cured by including in its provisions subjects within the domain of the state.' That portion of the tax which is measured by the receipts from foreign commerce necessarily varies in proportion to the volume of that commerce, and hence is a direct burden upon it. So obvious is the distinction between this tax and those that were sustained in *Maine v. Grand Trunk Ry. Co.*, 142 U. S., 217; *U. S. Express Co. v. Minnesota*, 223 U. S., 335; *Baltic Mining Co. v. Massachusetts*, 231 U. S., 68; *Kansas City Ry. v. Kansas*, 240 U. S., 227, and some other cases of the same class, that no time need be spent upon it." (Italics added)

In *Peck & Co. v. Lowe*, 247 U. S., 165, the Act of Congress of October 3d, 1913, c. 16, sec. 2, 38 Stat. 166, levying an annual tax on a domestic corporation of a specified per centum of its "entire net income arising or accruing from all sources during the preceding calendar year," is held not to be subject to the objection that it is unconstitutional as a tax or duty which directly burdens exportation. In the opinion in this case Mr. Justice Van Devanter says:

"It is not laid on income from exportation because of its source, or in a discriminative way, but just as it is laid on other income. The words of the act are 'net income arising or accruing from all sources.' There is no discrimination. At most, exportation is affected only indirectly and remotely. The tax is levied after exportation is completed, after all expenses are paid and losses adjusted, and after recipient of the income is free to use it as he chooses."

In 26 Ruling Case Law, page 144, it is said:

"It has been authoritatively held that a state may tax the entire *net income* of a corporation although part of such income is derived from interstate commerce, since such a tax is not in the nature of a burden laid on the busi-

ness, the gross receipts or the property employed in interstate commerce, but deals only with that part of the fruits of such commerce which remains as the net proceeds after all the immediate burdens of the commerce have been discharged," citing *U. S. Glue Co. v. Oak Creek*, 161 Wis. 311; s. c. 247 U. S., 231.

See also, 12 Corpus Juris, page 112 and cases cited in note 51

While the Supreme Court held in *Underwood Typewriter Company v. Chamberlain*, 41 S. C. Rep., 45 that a tax "measured by *net profits* is valid, although these profits may have been derived in part, or indeed mainly from interstate commerce," such decision does not in any way affect the prior decisions of the court declaring invalid taxes upon the *gross receipts* from interstate commerce, nor is such decision authority against the position of plaintiff.

The use of the words "an income tax *equivalent* to three per cent of the entire net income" is not sufficient to save this statute from the objection that it is a direct tax upon interstate commerce.

In *Galveston H. & S. A. R. Co. v. Texas*, 210 U. S., 217, in which a tax on gross receipts of an interstate railroad is held to be unconstitutional, the United States Supreme Court says:

"We are of the opinion that the statute levying this tax does amount to an attempt to regulate commerce among the states. The distinction between a tax 'equal to' 1 per cent of gross receipts, and a tax of 1 per cent of the same, seems to us nothing, except where the former phrase is the index of an actual attempt to reach the property and to let the interstate traffic and the receipts from it alone. We find no such attempt or anything to qualify the plain inference from the statute, taken by itself. On the contrary, we rather infer from the judgment of the state court and from the argument on behalf of the state that another tax on the property of the railroad is upon a valuation of that property, taken as a going concern. There is merely an

effort to reach the gross receipts, not even disguised by the name of an occupation tax, and in no way helped by the words 'equal to'. "Of course it does not matter that the plaintiffs in error are domestic corporations or that the tax embraces indiscriminately gross receipts from commerce within as well as outside of the state. We are of the opinion that the judgments should be reversed."

In the original enactment of the statute imposing on corporations the tax of three per cent of their net incomes, such tax was called "a franchise or excise tax with respect to carrying on or doing business." (Revenue Act of 1921, Section 201) By an act passed by the Special Session of 1921, this language was stricken from the act. It was evidently used in the original act in an effort to bring the tax with in the decision in *Spreckel Sugar Refining Co. v. McClain*, 192 U. S., 397, and upon second thought it was found that a franchise or privilege tax of one-tenth of one per cent of the assessed value of the property of corporations had already been levied and a second tax of the same nature would be clearly invalid.

In another way this income tax is a burden on interstate commerce. The State of North Carolina, by its tax laws, permits the counties, cities, towns, townships and special taxing districts to levy taxes on the assessed value of plaintiff's property known as an ad valorem tax, which is based upon the whole property of complaint, tangible and intangible, and to this tax laws of the state add to a so-called franchise tax of one-tenth of one per cent on the same assessed value, and by the income tax law, the Legislature of North Carolina has levied an additional tax characterized as an income tax of three per cent on complainant's net operating revenue, including revenue derived from interstate commerce. We submit that this system of pyramiding taxes and the entire scheme of taxation amounts to a regulation of commerce between the states, because necessarily a tax of one-tenth of one percent upon the tangible and intangible property of this complainant and a tax of three per-

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cent upon its net operating revenue, including revenue derived from interstate commerce, are taxes upon interstate commerce, the property, tangible and intangible, having already been taxed at its full value and this scheme of taxation levies a tax which is a burden upon the interstate commerce of plaintiff and violates the commerce clause of the Constitution of the United States, Section 8 of Article 1.

III

THE INCOME TAX ACT OF 1921 CREATES AN UNLAWFUL DISCRIMINATION AGAINST COMPLAINANT IN THE ATTEMPTED CLASSIFICATION OF RAILROADS AND OTHER PUBLIC SERVICE CORPORATIONS IN VIOLATION OF THE CONSTITUTION OF NORTH CAROLINA AND THE CONSTITUTION OF THE UNITED STATES.

The Income Tax Act of 1921 (Public Laws of 1921, ch. 34) in section 201 to 204, inclusive, and sections 300 to 306, inclusive, classifies corporations for the imposition of the income tax as follows:

(1) Corporations engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business or other form of public service *when such companies are required to keep records according to the standard classification of accounting of the Interstate Commerce Commission and whose business is in part within and part without the state*, are required to pay a tax equal to 3% of their gross operating revenues within the state, including therein the equal mileage proportion within this state of their interstate business and deducting therefrom the proportionate average of the operating expenses or operating ratio of their whole business as shown by the Interstate Commerce Commission standard classification of accounts, and from the amount thus ascertain is deducted uncollectible revenue and taxes paid in the state other than income taxes and war profits and excess profits taxes and there is also deducted any debit balance paid on account of car hire.

(2) Corporations engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service *when such companies are required to keep records according to the standard classification of accounting of the Interstate Commerce Commission and whose business is wholly within the state* are required to pay a tax equal to 3% of their "net operating income" as shown by their records kept in accordance with the standard classification of accounts with the deductions above set forth.

(3) Corporations engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service, *when such companies are not required to keep records according to the standard classification of accounting of the Interstate Commerce Commission* are required to pay a tax of 3% on net income similar to that imposed upon all other corporations by section 201 of the Income Tax Act and such corporations are allowed the deductions from their gross income set out in section 306 of the said act, which deductions are not allowed corporations referred to in (1) and (2) above.

(4) Corporations which own a steam or electric railroad, express service, telephone or telegraph business, or other form of public service and which are *not engaged in the operation* thereof, but have an income from other sources, such as leases, rentals, etc., are allowed the same deductions as other corporations and pay the tax only on net income.

(5) Every corporation organized under the laws of North Carolina and every foreign corporation doing business in the state, except the corporations referred to in paragraphs (1) and (2) are required to pay a tax equivalent to 3% of their *net income* and in arriving at net income such corporations are allowed the deductions set out in section 306 of the Income Tax Act.

The provisions of section 202 are restricted to corporations engaged in interstate commerce because by the terms of the

interstate commerce act only such corporations are required to keep their accounts according to the standard classification of accounting of the Interstate Commerce Commission. (Act to Regulate Commerce, Feb. 4th, 1887, c. 104, sec. 20, 24 Stat, 386 as amended; Barnes' Federal Code, 1921 Supplement, Sec. 7916.)

In the case of a corporation owning a railroad, which it does not operate, but leases to another railroad, and has an income from that and other sources, it is well settled that such corporation is not liable for an income tax imposed upon corporations "engaged in business."

McCoach v. Minehill & S. H. R. Co., 228 U. S., 295.

We submit that the classification of corporations for income taxation made by the Income Tax Act of 1921 is quite as unreasonable, arbitrary and illusory as that appearing in the Virginia law held to be unconstitutional by the United States Supreme Court in *Royster Guano Co. v. Virginia*, 253 U. S., 412; 40 S. C. Rep. 560, in which it is held:

(1) Acts of Virginia, 1916, c. 472, in so far as it imposes on a domestic corporation doing business both within and without the state a tax with respect to its income derived from sources outside the state, denies such corporation the equal protection of the laws, in violation of the Fourteenth Amendment, in view of Acts of Virginia, 1916, c. 495, exempting domestic corporations doing no part of their business within the state from any tax on their income; the classification being arbitrary.

(2) The equal protection of the laws required by the Fourteenth Amendment does not prevent the states from resorting to classification for the purposes of legislation.

(3) Under the Fourteenth Amendment, classification for purposes of legislation must be reasonable, and not arbitrary, and must rest upon some ground of difference having a fair and sub-

stantial relation to the object of the legislation, so that all persons similarly circumstanced shall be treated alike.

(4) While the latitude of discretion is wide in its classification of property for purposes of taxation, a discriminatory tax cannot be sustained against the complaint of a party aggrieved, if the classification is altogether illusory.

In discussing the subjects of classification of corporations for taxation, the Supreme Court of the United States has said:

"It remains to consider the argument made on behalf of the state of Alabama, that the statute is justified as an exercise of the right of classification of the subjects of taxation, which has been held to be entirely consistent with the equal protection of the laws guaranteed by the Fourteenth Amendment. It is argued that the imposition of special taxes upon foreign corporations for the privilege of doing business within the state is sufficient to justify such different taxation, because the tax imposed is different, in that the one imposed on the domestic corporation is for the privilege of being a corporation, whereas the one on the foreign corporation is for the privilege of such corporation to do business within the state. While reasonable classification is permitted, without doing violence to the equal protection of the laws, such classification must be based upon some real and substantial distinction, bearing a reasonable and just relation to the things in respect to which such classification is imposed; the classification cannot be arbitrarily made without any substantial basis. Arbitrary selection, it has been said, cannot be justified by calling it classification. *Gulf C. & F. R. Co. v. Ellis*, 165 U. S., 140; *Cotting v. Kansas City Stock Yards Co.* (*Cotting v. Godart*), 183 U. S., 79; *Conolly v. Union Sewer Pipe Co.*, 184 U. S., 540.

"It is averred in the complaint, and must be taken as admitted, that there are other corporations of a domestic character in Alabama, carrying on the railroad business

in precisely the same way as the plaintiff. It would be a fanciful distinction to say that there is any real difference in the burden imposed because the one is taxed for the privilege of a foreign corporation to do business in the state, and the other for the right to be a corporation. The fact is that both corporations do the same business in character and kind, and under the statute in question a foreign corporation may be taxed many thousands of dollars for the privilege of doing, within the state, exactly the same business as the domestic corporation is permitted to do by a tax upon its privilege, amounting to only a few hundred dollars.

"We hold, therefore, that to tax the foreign corporation for carrying on business under the circumstances shown, by a different and much more onerous rule than is used in taxing domestic corporations for the same privilege, is a denial of the equal protection of the laws, and the plaintiff being in position to invoke the protection of the Fourteenth Amendment, that such attempted taxation under a statute of the state does violence to the Federal Constitution."

Southern Ry. Co. v. Greene, 216 U. S., 400.

In *G. C. & S. F. R. Co. v. Ellis*, 165 U. S., 150, a leading case on the subject of discrimination by arbitrary selection under the guise of classification, the United States Supreme Court says:

"It is apparent that the mere fact of classification is not sufficient to relieve a statute from the reach of the equality clause of the Fourteenth Amendment, and that in all cases it must appear not only that a classification has been made, but also that it is based upon some reasonable ground, some difference which bears a proper relation to the attempted classification, and is not a mere arbitrary selection."

Bell's Gap R. Co. v. Pennsylvania, 134 U. S., 232;
Magoun v. Bank, 170 U. S., 283;

Keeny v. New York, 222 U. S., 525.

"Arbitrary section cannot be justified by calling it classification."

Southern Ry. Co. v. Greene, 216 U. S., 400.

In *State v. Williams*, 158 N. C., 610, this subject is discussed at some length by Mr. Justice Walker, and it is held that a town ordinance which required every person, firm or corporation in the state, soliciting or taking orders for goods to be delivered in the town by nonresident merchants, firms or corporations is discriminative and unconstitutional. In this case it is held:

(1) While the taxing of trades is not expressly included in the rule of uniformity declared by the Constitution of North Carolina, Article 5, Section 3, the courts, by interpretation, will subject it to the same rule because a different rule would be inconsistent with natural justice and with the intent as gathered from the section referred to.

(2) In laying a tax, the different subjects thereof may be reasonably, though not arbitrarily, classified, and a different rule of taxation prescribed for each class, provided the rule is uniform in its application to the class for which it is made. The result must be to prevent discrimination among individuals or subjects of any one class, based upon special privileges, immunities or exemptions allowed to one and not to others.

"Uniformity, in its legal and proper sense, is inseparably incident to the power of taxation, whether applied to taxes on property or to those imposed on trades, professions, etc."

State v. Moore, 113 N. C., 698.

In the case of *Worth v. Railroad*, 89 N. C., 291, the tax law under consideration provided for the taxation of three classes of railroads, and the taxes imposed upon one were not imposed

upon the other two. The three classes of railroads are described in the opinion at page 294, as follows:

"1. If the road is, by virtue of the contract contained in its charter, exempt from taxation upon its property or shares, a tax is levied upon the incorporation equal in amount to one per centum upon its gross receipts.

2. If it be exempt from liability to taxation upon its real estate held 'for right of way, for station places and workshop locations,' following the language of the exemption contained in the charter of the North Carolina railroad company, as amended in the act of February 14th, 1855, but is liable to a tax upon its franchise and personal estate, it is subject to a tax of one per centum upon the gross receipts.

3. If the property of the road be exempt, and it be not liable to the preceding tax, it was before subjected to a tax of one per cent upon the cash value of the shares, and by the act of 1881 instead, to what is termed a privilege tax of twenty-five dollars per annum for each mile of its track through its entire extent."

In holding that this method of the taxation of railroads violates the Constitution of North Carolina, Chief Justice Smith says:

"The first enumerated tax is not general in its application to railroads and canals, but is special and confined to such only as fall within the descriptive words of the statute, and the same is strictly true as to others. The obvious result of this legislation is to impose burdens on exempted roads, which are not imposed upon those unexempted, and pro tanto to counteract the effect of the discriminating privileges and immunities that would otherwise subsist between them.

If the same general burdens were put upon all alike, whatever might be the subject matter of the taxation, the favored roads would continue to possess and enjoy the

privileges conferred in their charter, and not found in the charters of the others. Indirectly than, the legislation tends to withdraw the immunities secured by their charters, and constituting a contract between the state and themselves, or lessen their value, so that all may proximately, at least, stand upon the same footing, as if none such had been conferred.

We should be reluctant to hold, if there were no question of constitutional right involved, that this method of levying taxes was sanctioned by our own constitution, and consistent with the equality and uniformity which it contemplates.

The 'uniform rule' to be observed in the exercise of the taxing power seems to be so far applicable to the taxes imposed on 'trades, professions, franchises and incomes,' as to require that no discriminating tax be imposed upon persons pursuing the same vocation, while varying amounts may be assessed upon vocations or employments of different kinds.

'Although it is not expressly provided that the tax on trades, &c., shall be uniform,' in the words of Rodman, J., delivering the opinion in *Gatlin v. Tarboro*, 78 N. C., 119, 'yet a tax not uniform, as properly understood, would be so inconsistent with natural justice, and with the intent which is apparent in the section of the constitution above cited (Art., 5, Sec. 3), that it may be admitted that the collection of such a tax would be restrained as unconstitutional.' This uniformity prescribed in the constitution of Illinois, as declared by Mr. Justice Miller, extends 'to the class upon which the law shall operate; that is, inn-keepers may be taxed by one, ferries by another, railroads by another (rule); provided, that the rule as to inn-keepers be uniform as to all inn-keepers; the rule as to ferries be uniform as to all ferries, and the rule as to railroad companies be uniform as to all railroad companies.' *Railroad Tax Cases*, 92 U. S., 575. The govern-

ing principle is not that the same specific tax shall be paid by each, as a form of capitation tax, but that, whether levied upon and measured by the amount of gross or net earnings or other standard, as upon real or personal estate, there shall be no discrimination made among the individuals of a class, based upon privileges and immunities secured to one under contract and not to another. The essential element in all systems of taxation is equality in imposing burdens upon the property of the tax-payers, so that each one, possessing the same species of property, shall pay the same proportionate tax as every other levied upon that property, and in this state such tax is required to be *ad valorem*."

The discrimination in the basis fixed for determining the taxable income of plaintiff and that for determining such income of individuals is for the reasons above set forth violative of the Constitution of North Carolina and the Constitution of the United States. Complainant is denied the deductions accorded individuals by the statute.

It is claimed by appellees that the denial to railroads of the right to deduct interest on their indebtedness is justified by the fact mortgage bond interest is more properly a capital charge. If this position is correct as to railroads, and we contend that it is not, it is equally applicable to other corporations which are financed by mortgage bond issues, and yet it appears in the record in this case at page 86 that numerous corporations doing business in North Carolina are allowed to deduct interest on large bonded indebtedness in arriving at their taxable net income.

IV

THE SCHEME OF TAXATION BY WHICH THE STATE GOVERNMENT IS SUPPORTED BY TAXES OTHER THAN *AD VALOREM*

TAX ON PROPERTY VIOLATES THE CONSTITUTION OF NORTH CAROLINA.

The legislature has not levied a tax on property for state purposes as required by Section 3, Article 5, of the Constitution of North Carolina.

Under numerous decisions of the Supreme Court of North Carolina, the provisions of this section that "laws shall be passed taxing by uniform rule all moneys, credits, investments in bonds, stocks, joint stock companies or otherwise; and also all real and personal property according to its true value in money" are mandatory and if the legislature levies any taxes for state purposes, it *must* levy an ad valorem tax.

Section 3 of the Revenue Act (Public Laws, 1921, Chap. 34) provides that no tax on any property in the state shall be levied for any of the purposes of the state government, and for the first time in the history of the State an attempt has been made to support the state government by the levy of income, franchise, inheritance and similar taxes. This is a radical departure from the tax system which has been in use in this State since the adoption of the Constitution, and violates the letter and the spirit of that instrument.

"It is the provision and was the purpose of the constitution that thereafter there should be no discrimination in taxation in favor of any class, person or interest, but that everything, real and personal, possessing value as property and the subject of ownership, shall be taxed equally and by uniform rule."

Kyle v. Commissioners, 75 N. C., 445 (397).

In *Commissioners v. Tobacco Co.*, 116 N. C., at page 446, Chief Justice Clark, then Associate Justice, says:

"As to corporations, by all authorities, it is in the power of the legislature to lay the following taxes, two or more of them in its discretion at the same time: 1. To tax the franchise (including in this the power to tax also

the corporate dividends). 2. The capital stock. 3. The real and personal property of the corporation. *This tax is imperative and not discretionary under the ad valorem feature of the constitution.* 4. The shares of stock in the hands of the stockholder. This is also imperative and not discretionary." (Italics added).

"The constitution, Art. 5, Sec. 3, commands that: Laws shall be passed taxing by a uniform rule all moneys, credits, investments in bonds, stocks, joint stock companies, or otherwise; and also all real and personal property according to its true value in money. It is apparent from an examination of the taxing laws of the State that the legislative department has attempted to observe and enforce *the mandate of the constitution.*" (Italics added).

Manning, J., in *Pullen v. Corporation Commission*, 152 N. C., at page 553.

"Whatever may have been the intention of the General Assembly in employing language so broad and comprehensive, we are forced to the conclusion that under the constitution of North Carolina all real and personal property owned and located within the borders of the State is subject to an ad valorem tax, and it is not to be supposed that the legislature intended to violate the fundamental law of the State, Art. V. Sec. 3, which requires in express terms that all real and personal property be taxed by a uniform rule according to its true value in money. In this respect the constitution 'shows no favor and allows no discretion.' *Wiley v. Commissioners*, 111 N. C., 397; *Puitt v. Commissioners*, 94 N. C., 709; *Vaughan v. Murfreesboro*, 96 N. C., 319. The imperative demand to levy the property tax upon the assessed value is in no way connected with the right to levy an inspection tax, or a tax on trades, professions, etc."

Guano Co. v. Biddle, 158 N. C., at page 214.

Section 3 Article V, is mandatory in requiring that taxa-

tion upon the property mentioned in it shall be ad valorem and that whatever tax is levied shall be uniform in its application.

R. R. v. Newbern, 147 N. C., 165.

Bickett v. Tax Commission, 177 N. C., 436.

In Smith v. Wilkins, 164 N. C., 140 Justice Allen says:

"In *State v. Worth*, 116, N. C., 1010, the court defines the term 'trades' as including any employment or business embarked in for gain or profit, and while the Constitution, Art. V, Sec. 3, is *mandatory* upon the General Assembly to levy a tax upon *all property by a uniform rule*, the authority to tax trades is permissive only, and no rule as to the method is prescribed."

In Lacy v. Packing Co., 134 N. C., page 573, it is said:

"The legislature is sole judge of what subjects it shall select for taxation (other than a property tax, which must be uniform and ad valorem) and the exercise of its discretion is not subject to approval of the judicial department of the State."

"By the Constitution, Art. V, Sec. 3, all the real and personal property in the state, is required to be taxed uniformly according to its value."

R. R. v. Commissioners, 72 N. C., 10.

Article VII, Sec. 9, provides that: "All taxes by any county, city, town or township shall be uniform and ad valorem upon all property in the same, except property exempted by this constitution." In construing this section in *Redmond v. Commissioners*, 106 N. C., 122, the Supreme Court held that it was not intended to apply the rules of uniformity to the subjects alone selected by the Legislature for the taxation in granting a municipal charter but requires that *all* property in the municipality shall be taxed, and taxed uniformly and equal. In the opinion of the Court, Justice Shepherd says:

"In the absence of constitutional limitations there is, it is

said, no restraint whatever upon the Legislature, and it may discriminate in favor of or against a particular class of persons or property, and pass laws in violation of every principle of just government, by an unequal distribution of the public burdens. The check upon such an abuse of power is in the influence of the constituents over their representatives; and the weight of authority is that the courts have no right to interfere with this exercise of the legislative will.

Thus it is seen that a wide field is open for a war between different classes of property, in that one class may be taxed to the exclusion or to the prejudice of another, and that under the forms of a free government, an excited partisan legislative majority may commit wrongs against the rights of property as flagrant and oppressive as those which have disgraced thereigns of the most despotic rulers.

But it is said that the General Assembly will be influenced by proper motives, and will levy taxes upon a just basis. Experience, in many of the states, has shown that the principles of taxation should not be left to the uncertainty of a caprice of successive legislatures, but that they should be fixed and immutable, and embodied in the fundamental law, under whose broad shield all property, of whatsoever species, may be equally protected.

This, we think, was the purpose of the framers of our Constitution in inserting therein the section referred to, as well as Section 3, Art. 5, relating to state taxation.

No one who reads these and other provisions of the Constitution will fail to be impressed with the earnest effort there made to engraft upon our organic law the great principle of equality in taxation."

It cannot be successfully contended that the levy of an ad valorem tax for county purposes complies with the requirements of Section 3 of Article 5 of the Constitution. Such tax is levied under Section 7 of Article 9, which relates to the levy

of taxes by counties, cities, towns and townships, and the requirement of uniformity applies only to the property within the borders of the county, city, etc. Certainly the county taxes are not uniform throughout the State, as required by Section 3 of Article 5.

In failing to levy a property tax for State purposes a greater proportion of the burden of taxation has been cast upon the complainant in that a proportionate part of the franchise tax of 1-10 of 1 per cent of the assessed value of its property, if this tax is valid as a franchise tax, and a proportionate part of the income tax were levied in lieu of the property tax demanded by the Constitution. The levy of a property tax for state purpose would have obviated in part, if not in whole, the necessity for an income tax.

V.

JURISDICTION TO ENJOIN COLLECTION OF THE INCOME TAX.

A Court of equity has jurisdiction to enjoin the collection of a tax in a suit wherein it appears that the levy of the tax casts a cloud upon complainant's title and there is no adequate remedy at law.

Shaffer v. Carter, 252 U. S., 37.

Ohio River & W. R. Co. v. Dittey, 232 U. S., 576.

The remedy at law, in order to exclude equity, must be as practical and efficient as the remedy in equity and must be as prompt and certain.

Tyler v. Savage, 143 U. S., 79.

Wells Fargo & Co. v. Johnson, 214 Fed. 180, 189.

A statute providing for payment under protest and suit to recover back is not an adequate remedy at law.

In re Tyler, 149 U. S., 164, 189.

Southern Ry. Co. v. Asheville, 69 Fed., 360.

King v. Northern Pacific R. Co., 196 Fed., 323.

Special statutory remedy does not exclude right of equity to enjoin.

Taylor v. L. & N. R. Co., 88 Fed., 350.

Gregg v. Sanford, 65 Fed., 151.

Income tax goes into treasury of State and complainant has no right to sue the State for its recovery.

Pyle v. Brenneman, 122 Fed., 787.

The jurisdiction extends to the disposition of all questions raised by the bill.

Shaffer v. Carter, 252 U. S., 37.

We submit, in conclusion, that for the reasons set forth herein the Income Tax Act of 1921 is invalid and the collection of the tax by defendants should be enjoined.

Respectfully submitted,

MURRAY ALLEN,

Counsel for plaintiff.

JAMES F. WRIGHT,
FORNEY JOHNSTON,
Of Counsel.

APPENDIX A.

Assignments of Error.

Filed Nov. 27, 1922.

In the District Court of the United States for the Eastern
District of North Carolina.

In Equity.

No. 447.

Seaboard Air Line Railway Company, Plaintiff,
against

A. D. Watts, Commissioner of Revenue of North Carolina,
et als., Defendants.

Now comes the plaintiff in the above entitled cause and, in connection with its petition for appeal from the decree entered November 13th, 1922, denying the application for a permanent injunction, files the following assignments of error:

THE COURT ERRED:

1. In decreeing that, upon consideration of the bill and answer, exhibits and evidence, plaintiff is not entitled to have the defendants or either of them enjoined and restrained from the performances of the duties imposed upon them by the statutes of North Carolina relating to the administration, assessing, levying and enforcement or collection of the income tax against the plaintiff.

2. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because said act is in violation of the Constitution of North Carolina and the Constitution of the United States, creates a discrimination against plaintiff and other railroad companies or similar character in favor of other corporations and individuals in that the said act in order to ascertain the taxable income allows other corporations and

individuals certain deductions, many of which said deductions are not allowed to plaintiff and the other railroad corporations of similar character.

3. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because, under the provisions of the Income Tax Act of 1921, and particularly Section 202, Section 300, and Section 306, all corporations which are required to keep records according to standard classification of accounting of the Interstate Commerce Commission, are required to pay a tax on their net income, which is defined by Section 300 as "the gross income of a taxpayer, less the deductions allowed by this act," whereas plaintiff and other railroads and public service corporations which are required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, are required to pay a tax on their net income, which is defined by Section 300 as "the gross income of a taxpayer, less the deductions allowed by this act," whereas plaintiff and other railroads and public service corporations which are required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, are not allowed the deductions set forth in the said act, except "uncollectible revenue" and taxes paid in the State for the income year other than income taxes, war profits and excess profits taxes, and certain deductions for car hire, and plaintiff and other railroad companies and public service corporations of similar character referred to in Section 202 of the Income Tax Act of 1921 are denied large deductions which are granted other corporations individuals and railroads not included in the provisions of Section 202, and particularly the deduction of interest paid during the income year, which results in discrimination against the plaintiff, in violation of the Constitution of North Carolina,

and denies the plaintiff the equal protection of the law and deprives it of its property without due process of law in contravention of the Fourteenth Amendment of the Constitution of the United States.

4. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because said act does not operate equally and uniformly upon all taxpayers in similar circumstances, and that the plaintiff and other railroads and public service corporations, which are required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, have been arbitrarily selected and taxed upon a more burdensome basis and one that is different from that applied to corporations in general and to other corporations engaged in business similar to that of plaintiff, in violation of the Constitution of North Carolina and plaintiff is thereby denied the equal protection of the law and is deprived of its property without due process of law in contravention of the Fourteenth Amendment of the Constitution of the United States.

5. In failing to hold that the plaintiff is entitled to an injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because said tax is not levied by a uniform rule as required by the Constitution of North Carolina, Article 5, Section 3, and the lack of uniformity works greatly to the detriment of plaintiff, in violation of said Article 5, Section 3, of the Constitution of North Carolina, and denies the plaintiff the equal protection of the law and deprives it of its property without the process of law, in contravention of the Fourteenth Amendment of the Constitution of the United States.

6. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because the classification of taxpayers for the purpose of fixing the income on which the tax shall be paid as made by the said Income Tax Act of 1921 is not based upon any reasonable ground, but is a mere arbitrary selection so far as as plaintiff and railroad companies of similar character are concerned, and was made for the purpose and has the result of imposing upon such railroad companies and corporations, including plaintiff, an unjust burden of taxation, in violation of the Constitution of North Carolina and denies the plaintiff the equal protection of the law and deprives it of its property without due process of law, in contravention of the Fourteenth Amendment of the Constitution of the United States.

7. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because the method of fixing plaintiff's taxable income as provided by Section 202 of the said Income Tax Act of 1921 violates the Constitution of North Carolina and the Constitution of the United States because it does not apply to railroads and public service corporations which derive their income from sources other than the operation of their property, which results in a lack of uniformity in the application of the income tax and in discrimination against plaintiff, and therein denies the plaintiff the equal protection of the law and deprives it of its property without due process of law, in contravention of the Fourteenth Amendment of the Constitution of the United States.

8. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the In-

come Tax Act of 1921 enacted by the Legislature of North Carolina is void, because the authority of the Legislature of North Carolina to tax incomes is derived from Section 3, Article 5, of the Constitution of North Carolina, and said section provides that only net incomes may be taxed, and in attempting to tax the "operating revenues" of plaintiff, the said act violates the Constitution of North Carolina and denies the plaintiff the equal protection of the law and deprives it of its property without due process of law, in contravention of the Fourteenth Amendment of the Constitution of the United States.

9. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because said act is violative of Article 5, Section 3, of the Constitution of North Carolina, for that it does not levy upon railroads and other public service corporations named in said Section 202, a tax on net income, but levies a tax upon the operating revenue derived from interstate and intrastate commerce, and does not permit the deductions necessary and incidental to the business of plaintiff and expended by it from said income in order to determine net income, and is in violation of the Interstate Commerce Clause, (Section 8, Article 1) of the Constitution of the United States, in that it permits a tax as an income tax to be placed upon gross income derived from interstate commerce, thereby burdening interstate commerce.

10. In failing to hold that the plaintiff is entiteled to the injunction as prayed for in bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because said act violates the Transportation Act of Congress and the Interstate Commerce Act, in that it seeks to prescribe a method of accounting by this inter-

state carrier, when said Acts of Congress have delegated the power to prescribe said accounting to the Interstate Commerce Commission and the said Commission has prescribed and directed that this plaintiff and other interstate carriers keep their accounts in accordance with the methods so prescribed by it.

11. Infailing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because the State of North Carolina, by its tax laws, permits the counties, cities, towns, townships and special taxing districts to levy taxes on the assessed value of plaintiff's property known as an ad valorem tax, which is based upon the whole property of plaintiff, tangible, and to this tax law of the State add a so-called franchise tax of one-tenth of one per cent on the same assessed value, and by the statutes hereinbefore referred to, the Legislature of North Carolina has levied and unless restrained the defendants in this action will undertake to collect an additional tax characterized as an income tax of three per cent on plaintiff's net operating revenue, including revenue derived from interstate commerce, and plaintiff avers that this system of pyramiding taxes and the entire scheme of taxation amounts to a regulation of commerce between the States, because necessarily a tax of one-tenth of one per cent upon the tangible and intangible property of this plaintiff and a tax of three per cent upon its net operating revenue, including revenue derived from interstate commerce, are taxes upon interstate commerce, the property, tangible and intangible, having already been taxed at its full value and plaintiff shows that this scheme of taxation levies a tax and burden upon the interstate commerce of plaintiff and violates the Commerce Clause of the Constitution of the United States, Section 8 of Article 1.

12. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the

income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because the penalties imposed for failure to comply with the Income Tax Act enacted by the Legislature of North Carolina are so excessive as to be violative of plaintiff's rights under the Constitution of the United States.

13. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because the plaintiff has no adequate remedy at law.

14. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void for that the levying of the income tax casts a cloud upon plaintiff's title.

MURRAY ALLEN,
Solicitor for Plaintiff.

TRANSCRIPT OF RECORD.

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1922.

No. 756.

SOUTHERN RAILWAY COMPANY, APPELLANT,

vs.

**A. D. WATTS AND A. D. WATTS, AS COMMISSIONER OF
REVENUE OF THE STATE OF NORTH CAROLINA,
ET AL.**

**APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR
THE EASTERN DISTRICT OF NORTH CAROLINA.**

FILED DECEMBER 22, 1922.

(29,306)

(29,306)

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1922.

No. 756.

SOUTHERN RAILWAY COMPANY, APPELLANT,

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ET AL.

APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR
THE EASTERN DISTRICT OF NORTH CAROLINA.

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TRANSCRIPT OF RECORD.

In the District Court of the United States for the Eastern District of North Carolina.

At a District Court of the United States for the Eastern District of North Carolina begun and held at the court-house, in the city of Raleigh, on the fourth Monday after the fourth Monday in October, being the 20th day of November, in the year of our Lord one thousand nine hundred and twenty-two.

Present: The Honorable Henry G. Connor, Judge of the District Court for the Eastern District of North Carolina.

Among others were the following proceedings, to-wit:

In Equity.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS, Individually and as Commissioner of Revenue of North Carolina, et al.

Bill of Complaint.

Filed March 31, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. —.

SOUTHERN RAILWAY COMPANY, Complainant,

vs.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, et al., Defendants.

To the Honorable H. G. Connor, Judge of the District Court of the United States for the Eastern District of North Carolina:

The Southern Railway Company, a corporation chartered and existing under and by virtue of the laws of the State of Virginia, and a resident of said State, brings this its bill of complaint against

A. D. Watts, individually, and as Commissioner of Revenue of the State of North Carolina, and a citizen of North Carolina, with his official residence at Raleigh, in the County of Wake,

State of North Carolina, in this judicial district of the United States; and James S. Manning, Attorney General of the State of North Carolina, and a citizen and resident of Raleigh in said state and district.

And respectfully shows the Court:

1. The Complainant is now, and was at all times hereinafter mentioned, a corporation of the State of Virginia engaged in the business of operating a railroad in said State and in the State of North Carolina, and also into and through the States of South Carolina, Georgia, Florida, Alabama, Mississippi, Tennessee, Kentucky, Indiana and Illinois, and the District of Columbia, and is now and was at all other times herein mentioned engaged in interstate commerce. The name, citizenship, and residence of the Defendants to this action is as above set forth.

2. This is a suit in equity and arises under the Constitution and Laws of the United States, as will presently more fully appear, and the amount involved in this suit, exclusive of interest and costs, is in excess of Three Thousand Dollars (\$3,000.00). The Complainant brings this suit to restrain the Defendants from levying,

4 assessing, and collecting certain income taxes from the Complainant and out of its property in North Carolina under color of the several statutes of North Carolina hereinafter mentioned. The Complainant respectfully shows that unless the Defendants and each of them be restrained from enforcing collection of said taxes, it will be deprived of privileges and immunities guaranteed and secured to it by the Constitution of the United States and the Fourteenth Amendment thereof; and further that it will be deprived of its property without due process of law and will likewise be denied the equal protection of the law, in contravention of the Constitution of the United States and the Fourteenth Amendment thereof. The Complainant also shows that the taxes sought to be imposed by virtue and under the authority of the North Carolina statutes constitute a direct burden upon interstate commerce in violation of the Commerce Clause of the Federal Constitution.

3. The levy of an income tax in the State of North Carolina is authorized by Article 5, Section 3 of the Constitution of North Carolina, which is as follows:

"Sec. 3. Taxation Shall be by Uniform Rule and ad Valorem-Exemptions. Laws shall be passed taxing, by a uniform rule, all moneys, credits, investments in bonds, stocks, joint-stock companies or otherwise; and, also, all real and personal property, according to its true value in money: Provided, notes, mortgages, and all other evidence of indebtedness given in good faith for the purchase price of a home, when said purchase price does not exceed three thousand dollars, and said notes, mortgages, and other evidence of indebtedness shall be made to run for not less than five nor more than twenty years, shall be exempt from taxation of every kind; Provided, that the interest carried by such notes and mortgages shall not exceed five and one-half per cent. The general assembly may also tax trades, professions, franchises, and incomes

Provided, the rate of tax on income shall not in any case exceed six per cent (6%), and there shall be allowed the following exemptions, to be deducted from the amount of annual incomes, to-wit: for a married man with a wife living with him, or to a widow or widower having minor child or children, natural or adopted, not less than \$2,000; to all other persons not less than \$1,000, and there may be allowed other deductions (not including living expenses) so that only net incomes are taxed.' "

4. The Legislature of North Carolina at its regular session of 1921 enacted an income tax law as a part of the Revenue Act of 1921, being Chapter 34 of the Public Laws of North Carolina of 1921. This Act will hereinafter be referred to as The Income Tax Act of 1921.

5. The Complainant refers to and sets forth the following sections of The Income Tax Act of 1921, as amended by the General Assembly of North Carolina, Special Session of 1921:

6 "Sec. 101. Purpose.—The general purpose of this act is to impose a tax, for the use of the State Government, upon the net income for the calendar year 1921, in excess of exemptions here set out, collectible in the year 1922, and annually thereafter:

- (a) Of every citizen of the State;
- (b) Of every domestic corporation;
- (c) Of every foreign corporation and of every non-resident individual having a business or agency in this State, in proportion to the net income of such business or agency.

"Except as otherwise provided in this act the purpose is to conform to the definitions of income in the revenue laws of the United States Government and regulations made under its authority, in so far as they apply.

"The tax imposed upon the net income of corporations in this schedule is in addition to the tax imposed under Schedule C of this Act."

"Sec. 201. Corporations.—Every corporation organized under the laws of this State shall pay annually an income tax equivalent to three per cent of the entire net income of such corporation as herein defined, received by such corporation during the income year; and every foreign corporation doing business in this State shall pay annually an income tax equivalent to three per cent of a proportion of its entire net income, to be determined according to the following rules:

"In case of a company other than companies mentioned in the next succeeding section, deriving profits principally from the ownership, sale, or rental of real estate or from the manufacture, sale, or use of tangible personal property, such proportion of its entire net income as the fair cash value of its real estate and

tangible personal property in this State on the date of the close of the fiscal year of such company in the income year is to be the fair cash value of its entire real estate and tangible personal property then owned by it, with no deduction on account of incumbrances thereon.

"In case of a corporation deriving profits principally from the holding or sale of intangible property, such proportion as its gross receipts in this State for the year ended on the date of the close of its fiscal year next preceding is to its gross receipts for such year within and without the State."

"Sec. 202. Railroads and Public Service Corporations.—The basis of ascertaining the net income of every corporation engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the standard classification of accounting of the Interstate Commerce Commission,

8 shall be the 'net operating income' of such corporations as shown by their records kept in accordance with that Standard Classification of Accounts, when their business is wholly within this State, and when their business is in part within and in part without this State, including in their gross 'operating revenues' within this State the equal mileage proportion within this State of their interstate business and deducting from their gross 'operating revenues' the proportionate average of 'operating expenses,' or 'operating ratio,' for their whole business, as shown by the Interstate Commerce Commission Standard Classification of Accounts. From the net operating income thus ascertained shall be deducted 'uncollectible revenue,' and taxes paid in this State for the income year other than income taxes and war profits and excess profits taxes, and the balance shall be deemed to be their net income taxable under this act."

The foregoing section relating to the basis of ascertaining the net income of railroads was supplemented by Chapter 35 of the Public Laws of 1921, as follows:

"Sec. 1. That in determining the taxable income of a corporation engaged in the business of operating a railroad under section two hundred and two of the act to raise revenue, in the case of a railroad located entirely within this State, the net operating income shall be increased or decreased to the extent of any credit or debit balance received or paid, as the case may be, on account of car hire; and when any railroad is located partly within and partly without this State, then said net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid, as the case may be, on account of car hire."

9 Section 203 of the Income Tax Act of 1921, as amended by Chapter 35, Public Laws of 1921, is as follows:

"Sec. 203. Such tax shall first be levied, collected, and paid in the year 1922, and with respect to the net income received during the calendar year 1921 and annually thereafter."

Section 3 of Chapter 34, Public Laws of 1921, provides:

"No tax on any property in the State shall be levied for any of the uses of the State Government. The taxes hereinafter levied in this act are for the expenses of the State Government, the appropriations to its educational, charitable, and penal institutions, pensions for Confederate soldiers and widows, the interest on the debt of the State, an equalizing fund for public schools, and other specific appropriations made by law, and shall be collected and paid into the general fund of the State Treasurer."

"Sec. 306. Deductions.—In computing net income there shall be allowed as deductions:

"1. All the ordinary and necessary expenses paid during the income year in carrying on any trade or business, including:

"(a) As to individuals, wages of employees for services actually rendered in producing such income.

"(b) As to partnerships, wages of employees and a reasonable allowance for co-partners or members of a firm, for services actually rendered in producing such income, the amount of such salary allowance to be included in the personal return of the co-partner receiving same.

"(c) As to corporations, wages of employees and salaries of officers, if reasonable in amount, for services actually rendered in producing such income.

"2. Rentals or other payments required to be made as a condition of the continued use or possession, for the purposes of the trade of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

"3. All interest paid during the income year on indebtedness except interest on obligations contracted for the purchase of non-taxable securities. Dividends on preferred stock shall not be deducted as interest.

"4. Taxes for the income year, except taxes on income and war profits, and excess profits taxes, inheritance taxes, and taxes assessed for local benefit of a kind tending to increase the value of the property assessed.

"5. Dividends from stock in any corporation, the income of which shall have been assessed and the tax on such income paid by the corporation under the provisions of this act; Provided, that when only part of the income of any corporation shall have been assessed under this act only a corresponding part of the dividends received therefrom shall be deducted.

"6. Losses sustained during the income year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit.

"7. Debts ascertained to be worthless and charged off within the income year, if the amount has previously been included in gross income in a return under this act.

"8. A reasonable allowance for the depreciation and obsolescence of property used in the trade or business; and, in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion: Provided, that in computing the deductions allowed under this paragraph, the basis shall be the cost (including in the case of mines, oil and gas well-, and other natural deposits, the cost of development, not otherwise determined), and in the case of property acquired prior to January 1, 1921, the fair market value of the property (or the taxpayer's interest therein) on that rate shall be taken in lieu of cost up to that date. The reasonable allowances under this paragraph shall be made under rules and regulations to be prescribed by the Tax Commission. In the case of leases the deductions allowed may be equitably apportioned between the lessor and lessee.

"9. In the case of taxpayers who keep regular books of account, upon an accrual basis, and in accordance with standard accounting practice, reserves for bad debts and for contingent liabilities, under such rules and restrictions as the Tax Commission may impose. If the Tax Commission shall at any time deem the reserve excessive in amount, it may restore such excess to income, either in a subsequent year or as a part of the income of the income year and assess accordingly.

"10. Contributions or gifts made within the taxable year to corporations or associations operated exclusively for religious, charitable, scientific or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, to an amount not in excess of fifteen per centum of the taxpayer's net income as computed without the benefit of this subdivision.

"11. Resident individuals having an established business in another State, or investment in property in another State, may deduct the net income from such business or investment if such business or investment is in a State that levies a tax upon such net income. The deduction authorized in this subsection shall in no case extend to any part of income of resident individuals from personal services, or mortgages, stocks, bonds, securities and deposits.

"12. In the case of a non-resident individual, the deduction allowed in this section shall be allowed only if, and to the extent that, they are connected with income arising from sources within the State; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the

State shall be determined under rules and regulations prescribed by the State Tax Commission."

6. Complainant is engaged in operating an interstate railroad and keeps its accounts in accordance with the Standard Classification of Accounts prescribed by the Interstate Commerce Commission and is required to pay an income tax under the appropriate part of Section 202 of The Income Tax Act or suffer the penalties prescribed in said Act.

Complainant respectfully shows the Court that the said Act is void as to complainant for the following reasons:

(a) Article 5, Section 3 of the Constitution of North Carolina authorizes the levy of a tax upon net incomes, and the statutory method prescribed in Section 202 for complainant and like corporations in order to arrive at net income results in the tax being levied on a sum which is not in truth and in fact net income, but includes a part of complainant's operating revenue in this:

Section 202 provides that railway corporations in the class of complainant shall first arrive at gross operating revenue within the State, including an equal mileage proportion within the State of its interstate business, and from this gross revenue shall deduct the following items:

(1) Proportionate average of operating expenses, as shown by the Interstate Commerce Commission Standard Classification of Accounts.

(2) Uncollectible revenue.

(3) Taxes paid in North Carolina for the income year, other than income taxes and war profits and excess profits taxes.

(4) An equal mileage proportion of car hire.

"and the balance shall be deemed to be their net income taxable under this Act." There is attached hereto as Exhibit "A" and made a part hereof an exact copy of the form furnished to complainant by the Revenue Department of the State of North Carolina, with the blanks for the figures filled in by complainant in accordance with said Section 202. This exhibit shows that complainant would be required to pay under Section 202 a tax of \$71,522.06. The Standard Classification of Accounts promulgated by the Interstate Commerce Commission under the provisions of the Interstate Commerce Act directs that there be deducted by railroads engaged in interstate commerce from their operating income in order to arrive at net income the following deductions in addition to those set forth in Section 202:

Joint Facility Rents;
Rent for Leased Roads;
Miscellaneous Rents;

Miscellaneous Tax Accruals;
 Separately Operated Properties—Loss;
 Interest on Funded Debt;
 Interest on Unfunded Debt;
 Amortization of Discount on Funded Debt;
 Maintenance of Investment Organization;
 Income Transferred to Other Companies;
 Miscellaneous Income Charges;

There is attached hereto, marked Exhibit "B," a "Statement of income applicable to State of North Carolina for year ended December 31, 1921, according to the Classification of Accounts prescribed by the Interstate Commerce Commission." This exhibit shows that if the income tax had been levied on that basis, the amount due by

complainant would be \$16,641.73. There is attached hereto, marked Exhibit "C," a statement of certain further deductions under the Interstate Commerce Commission's Classification of Accounts which should be allowed before arriving at net income. The amounts shown on Exhibit "C" are by the Commission permitted to be charged to profit and loss and are so charged by complainant on its books, but they are none the less proper deductions before arriving at net income and the Commission so permits and the Internal Revenue Department of the United States Government so permits in arriving at net income to be taxed under the Federal Income Tax Law. These further deductions being made, it is shown that this complainant would be required to pay an income tax of \$13,703.95.

Complainant avers that the foregoing facts disclose, first, that the method of arriving at net income as set forth in Section 202 does not produce net income and hence violates Article 5, Section 3 of the Constitution of North Carolina and is contrary to Section 101 of the Income Tax Act of 1921, and is void and the enforcement of said void statute denies to complainant the equal protection of the law and deprives it of its property without due process of law in contravention of the Fourteenth Amendment to the Constitution of the United States; and, second, since the net income includes a proportion of

interstate revenue and Section 202 of The Income Tax Act does not permit deduction of all the items which the Interstate Commerce Commission's Classification of Accounts permits to be deducted, the result is that the tax is levied in part upon gross revenue derived from interstate commerce, and is, therefore, a direct burden upon interstate commerce contrary to the Commerce Clause of the Constitution of the United States.

(b) Section 202 permits only the deductions set forth in said section as shown in Exhibit "A," which is a copy of the tax return required by the State Department of Revenue, while under Section 306 of The Income Tax Act individuals and corporations, other than those referred to in Section 202, are permitted deductions set forth in twelve numbered paragraphs and as shown in Section 306 above. The non-allowance to complainant of such of said deductions as are

applicable to complainant and are allowed by the law to individuals and other corporations discriminates against complainant and renders the law invalid. For illustration, there is no reason in law why other corporations and individuals should be permitted, in computing net income, to deduct "rentals or other payments required to be made as a condition of the continued use or possession, for the purposes of the trade of property to which the taxpayer has not taken or is not taking title or in which he has no equity" (paragraph 2 of

18 Section 306) or "all interest paid during the income year on indebtedness, except interest on obligations contracted for the purchase of non-taxable securities" (paragraph 3 of Section 306), while railroads are not permitted such deductions. This is such an arbitrary and unreasonable classification and discrimination against complainant as to deny to complainant the equal protection of the laws in violation of the Fourteenth Amendment to the Constitution of the United States and in violation of the Uniformity Section of the Constitution of the State of North Carolina, and works to the actual damage of complainant, as is shown by Exhibit "B" hereto attached, in the sum of many thousands of dollars.

(c) Section 202 is void because it prescribes one method of ascertaining net income of a corporation engaged in the business of operating a railroad or other form of public service, when such company is required to keep records according to the Standard Classification of Accounting of the Interstate Commerce Commission, and a different method is prescribed in said Act for such corporations who do not keep their records according to the Standard Classification of Accounts. This creates a discrimination against complainant, which does keep its records according to the Standard Classification of Accounts, in that other corporations in the same class but which do not keep their accounts according to the Standard Classification of the Interstate Commerce Commission pay less taxes than they would if they so kept their accounts. This classification is so unreasonable as to be arbitrary and it violates the Uniformity Section of the Constitution of North Carolina and violates the Fourteenth Amendment to the Constitution of the United States.

(d) Complainant shows that the State of North Carolina, by its tax laws, permits the counties, cities, towns, townships and special taxing districts to levy taxes on the assessed value of complainant's property known as an ad valorem tax, which is based upon the whole property of complainant, tangible and intangible, and to this the tax laws of the State add a so-called franchise tax of one-tenth of one per cent on the same assessed value, and by the statutes hereinbefore referred to, the Legislature of North Carolina has levied, and unless restrained the defendants in this action will undertake to collect, an additional tax characterized as an income tax of 3 per cent on complainant's net operating revenue, including revenue derived from interstate commerce, and complainant avers that this system of pyramiding taxes and the entire scheme of taxation amounts to a regulation of commerce between the States, because necessarily a tax of one-tenth of one per cent upon the tangible and

intangible property of this complainant and a tax of 3 per cent upon its net operating revenue, including revenue derived from interstate commerce, are taxes upon interstate commerce, the property, tangible and intangible, having already been taxed at its full value, and complainant shows that this scheme of taxation levies a tax and burden upon the interstate commerce of complainant and violates the Commerce Clause of the Constitution of the United States, Section 8, Article 1.

(c) Complainant further shows that the statutes imposing an income tax upon complainant are unconstitutional and void in that they are violative of the scheme of taxation created and made mandatory by the Constitution of North Carolina. That instrument provides a dual system of taxation, one set of taxes being leviable by the State and the other by the counties and other governmental subdivisions. The complainant, therefore, avers that the scheme of taxation brought about by the tax laws of North Carolina, whereby the State derives its entire revenue from taxes other than a tax on property is unwarranted by the Constitution of North Carolina, which by its mandate requires that all property shall bear its just proportion of the burden of taxation and that laws shall be passed taxing by uniform rule all moneys, credits, investments in bonds, stocks, joint stock companies or otherwise, and also all real and personal property according to its true value in money (Article 5, Section 3) and the complainant shows that the North Carolina Legislature has no power to exempt a large class of property from liability to taxation for State purposes as is done by Section 3, Chapter 34, Public Laws of 1921, and recoup the loss of revenue thereby occasioned by taxes other than a tax on property. Such method or scheme of taxation is plainly at variance with that intended to be established by the Constitution of North Carolina, and consequently Section 202, which attempts to impose a part of the additional burden of taxation upon the complainant, is void, in that it violates the Constitution of North Carolina and denies the complainant the equal protection of the law and deprives the complainant of its property without due process of law in violation of the Fourteenth Amendment to the Constitution of the United States; and complainant further shows that the said scheme of taxation is unconstitutional and void in that the complainant is charged with an undue proportion of the burden of taxation than is warranted by the Constitution of North Carolina in that complainant is required by the tax laws of North Carolina to pay to counties, cities and towns and special tax districts large sums as taxes on the assessed value of its property, \$96,306,357.00, and in addition thereto a so-called franchise tax of one-tenth of one per cent on its assessed value of \$96,306,357.00 and the income tax of 3 per cent on its net operating revenue.

7. Complainant shows that the form for the income tax returns for the calendar year ended December 31, 1921, was received by complainant, which requires said return to be made in conformity with the provisions of Section 202 of The Income Tax

Act of 1921. The law would require complainant to file said return and to pay the full amount of the tax on or before the fifteenth day of March, 1922, but, due to the fact that an amendment to a bill then pending in the Federal Court for the Western District of North Carolina against the Commissioner of Revenue had set up the invalidity of the said income tax law, the Commissioner of Revenue of North Carolina has extended the time for the filing of said return, and at this date the court in that case has held that the income tax was not before it. Complainant will, therefore, unless protected by order of this court, have to file said return and make said payment of \$71,522.06, as shown by Exhibit "A" hereto attached, whereas its true tax should not be in excess of \$13,703.95, as shown by Exhibit "C" hereto attached, and unless defendants are restrained and enjoined from so doing, the Commissioner of Revenue will proceed, under Section 504, to issue an order directed to the Sheriff of any county of the State, commanding him to levy upon and sell the real and personal property of the complainant for the payment of the amount of said tax, with the added penalties, interest and cost of exacting the same, and the Sheriff is directed in said Section 504 to proceed in all respects and in the manner prescribed with respect to executions issued against property upon judgments of a court of record. Furthermore, the sale of said property may be for the added penalties, which are set forth in Section 600 of said Act, which is in part as follows:

"If any taxpayer fails voluntarily to file a return of income or pay a tax, if one is due, within sixty days of the time required by or under the provisions of this act, the tax shall be doubled, and such doubled tax shall be increased by one per cent for each month or fraction of a month from the time the tax was originally due to the date of payment."

The Attorney General is directed, in addition to other penalties, in sub-section 5 of Section 600, as follows:

"Any person who, without fraudulent intent, fails to pay any tax or to make, render, sign or verify any return, or to supply any information, within the time required by or under the provisions of this act, shall be liable to a penalty of not more than one thousand dollars, to be recovered by the Attorney General, in the name of the people, by action in any court of competent jurisdiction."

and unless restrained will proceed against complainant as directed by said law, to the great damage and embarrassment of complainant. The lien created by said Act upon the property of complainant would be a cloud upon its property, and the enforcement of said tax by execution would interfere with the conduct of complainant's business as an interstate carrier.

Complainant further shows that the penalties prescribed as set forth above are excessive, unreasonable, oppressive and inequitable, and that it is a denial of due process of law for the said Act to impose such penalties upon the complainant, who is proceeding with

due diligence to have it judicially determined whether or not the said Act is valid, the complainant in good faith asserting that said Act is not valid. Complainant therefore avers that even though the said Act should finally be declared valid, such penalties should not be imposed upon complainant.

Complainant avers that it has made no tender of any tax to the Commissioner of Revenue because it is advised that Section 202 is the only section applicable to it, and inasmuch as Section 202 is for the reasons herein set out, believed to be void, no tender would be proper, and for the further reason that it is advised that Section 202 is mandatory and that the Commissioner of Revenue has not the right to accept payment on any basis other than that set forth in said Section 202, and it has not, therefore, done the vain act of making a tender, but it expresses a willingness, if any plan may be devised or

25 the State is willing to accept a payment of income tax on the basis herein averred to be correct, to immediately make payment thereof.

Wherefore and for as much as complainant is remediless in the premises according to the common law, and remediable only in equity, and that complainant may not suffer irreparable injury and damage and may be permitted to pursue and carry on its business without unlawful hindrance and destruction, and that the railroad by complainant operated in the State of North Carolina as aforesaid and its other property in the State may not be subjected to illegal liens and clouds, complainant prays for a writ of subpoena to issue against the defendants and each of them to appear and full and true answer make to this bill of complaint, but not under oath, answer under oath being hereby waived, and that said defendants and each of them be enjoined by final decree, and, meanwhile, by a preliminary injunction as follows, to-wit:

That said A. D. Watts, Commissioner of Revenue of North Carolina, be enjoined and restrained from taking or causing to be taken any action toward enforcing the filing of a return or the collection of a tax or any part thereof, which the said Income Tax Act of 1913 imposes upon the complainant or its property in the State of North Carolina.

26 That James S. Manning, as Attorney General of North Carolina, be enjoined and restrained from instituting or authorizing the institution of any suit or proceedings to collect the said tax or any penalties as provided in said Income Tax Act.

Complainant further prays that the tax statutes of North Carolina herein alleged to be unlawful be decreed by this court to be unconstitutional and invalid, and that no assessment for taxation be made against the complainant thereunder, and no tax be levied against or collected from the complainant thereunder, and that no penalties be inflicted upon the complainant under the said Act; and for all such other, further, general and special relief to which in equity it may be entitled.

This is the first application for injunction in this case.

S. R. PRINCE,
Solicitor for Complainant.

L. E. JEFFRIES,
MANLY, HENDREN & WOMBLE,
C. O. AMONETTE,
Of Counsel.

DISTRICT OF COLUMBIA,
City of Washington:

F. S. Wynn, being duly sworn, deposes and says that he is Vice President of the Southern Railway Company, the above-named complainant, which is a corporation; that he has read the foregoing bill of complaint and knows the contents thereof; that the same is true of his own knowledge, except as to matters therein stated on information and belief, and as to those matters he believes it to be true.

F. S. WYNN.

Subscribed and sworn to before me this 29th day of March, 1922.

[SEAL.]

HARRY K. PIMPER,
Notary Public, District of Columbia.

EXHIBIT A.

State Department of Revenue.

Public Service Corporation Income Tax Return (Railroads).

For Calendar Year Ending December 31, 1921.

Name: Southern Railway Company.

Business Address: 1300 Pennsylvania Avenue, N. W., Washington, D. C.

We, the undersigned, president and treasurer of the corporation in which this return is made, being severally duly sworn, each for myself deposes and says that this return, including the accompanying schedules and statements, has been examined by him and is, to the best of his knowledge and belief, a true and complete return made in good faith, for the taxable year as stated, pursuant to the Revenue Act for 1921 and the Regulations issued under authority thereof.

President.

Treasurer.

Sworn to and subscribed before me this — day of —, 1922.

(Official capacity.)

*Net operating income (when business is wholly within the State).....	.....
*Net operating revenue, including equal mileage proportion within this State of the interstate business (when business is in part within and in part without the State).....	\$24,501,334.44	
Other income.....	.....
Total Income.....		\$24,501,334.44
*Operating expenses (when business is wholly within the State).....	.....
*Proportionate average of operating expenses (when business is in part within and in part without the State).....	\$20,144,997.18	
*Uncollectible revenue.....	14,882.50	
Taxes paid in this State, other than income and war profits and excess profits taxes.....	1,368,000.00	
Total deductions.....		21,527,879.68
Operating income, less deductions.....		\$2,973,454.76
Plus or Minus any credit or debit balance received or paid on account of car hire. And when any railroad is partly within and partly without the State then said net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid.....		589,386.60
Net taxable income.....		\$2,384,068.16
Tax at 3%.....		71,522.05
Main track mileage (system).....		6,971.86
Main track mileage (State, including trackage).....		1,219.30

EXHIBIT B.

Southern Railway Company.

Office of Comptroller.

Statement of Income Applicable to State of North Carolina for Year Ended December 31st, 1921, According to the Classification of Accounts Prescribed by the Interstate Commerce Commission.

I. Operating Income:

501. Railway Operating Revenues.....	\$24,501,334.44
531. Railway Operating Expenses.....	20,144,997.18
Net Revenue from Railway Operations.....	\$4,356,337.26
532. Railway Taxes Paid.....	1,368,000.00
533. Uncollectible Railway Revenues.....	14,882.50
Railway Operating Income.....	\$2,973,454.76

*As per standard Classification of Accounts of Interstate Commerce Commission.

II. Non-operating Income:

Equipment Rents (Accounts 503 to 507 and 536 to 540).....	*\$596,348.84
508. Joint Facility Rent Income.....	66,886.47
510. Miscellaneous Rent Income.....	46,122.71
511. Miscellaneous Non-operating Physical property	17,782.91
513. Divided Income.....	24,538.67
514. Income from Funded Securities.....	272,578.63
515. Income from Unfunded Securities and Accounts	166,488.54
519. Miscellaneous Income.....	13,791.04
Total Non-operating Income..	\$11,540.13
Gross Income.....	\$2,984,994.89

III. Deductions from Gross Income:

541. Joint Facility Rents.....	\$213,767.07
542. Rent for Leased Roads.....	591,491.75
543. Miscellaneous Rents.....	1,981.35
546. Interest on Funded Debt.....	1,481,391.58
547. Interest on Unfunded Debt.....	116,151.96
551. Miscellaneous Income Charges.....	25,486.77
Total D-uctions from gross Income	\$2,430,270.48
Net Income	\$554,724.41
Tax @ 3%.....	\$16,641.73

Washington, D. C., March 21st, 1922.

EXHIBIT C.

Southern Railway Company.

Office of Comptroller.

Statement of Amounts Deductible from Income Applicable to State of North Carolina for Year Ended December 31, 1921, Which Amounts According to the Classification of Accounts Prescribed by the Interstate Commerce Commission are Chargeable to Profit and Loss.

Discount extinguishable thru Surplus.....	\$71,728.88
Miscellaneous Debits	26,196.97

(Bad debts written off during the year accrued in North Carolina.)

This figure shows loss under said accounts.

Total Further Deductions.....	\$97,925.85
From Net Income as Shown by Exhibit B.....	554,724.41
Leaving Taxable Net Income to be.....	\$456,798.56
Tax at 3%.....	13,703.96

31 *Application for Interlocutory Injunction.*

Filed March 31st, 1922.

In the District Court of the United States for the Eastern District of
North Carolina.

In Equity.

No. —.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, et al.

Comes the above named plaintiff and shows the court:

That it has instituted in this Court by bill of complaint an action against A. D. Watts, individually, and as Commissioner of Revenue of the State of North Carolina and against James S. Manning, Attorney General of said State, as shown in said bill which is now referred to and made a part of this application, the object and purpose of the action being to secure from this Honorable Court an order preliminarily and perpetually enjoining the defendants, who are charged with the duty of collecting income taxes under The Income Law of 1921 of North Carolina, from taking or causing to be taken any action toward enforcing the filing of a return of the collection of a tax or any part thereof under the said Income Tax Act of 1921, and from instituting or authorizing the institution of any suit or proceedings to collect the said tax or any penalties as provided in said Income Tax Act, on the ground that said income tax in the manner imposed upon petitioner is contrary to the Constitution and laws of North Carolina and the Constitution of the United States. The bill alleges and sets forth the grounds of unconstitutionality of the said income tax assessment and of the Income Tax Act of 1921 under which said invalid assessment was made and under which the illegal taxes will be collected by the defendants named in said bill unless restrained by this Honorable Court, all of which is more fully alleged, set out, and explained in the bill of complaint filed herein.

Under the provisions of the said Income Tax Act of 1921 of North Carolina, it is required that a return be filed on or before the 15th day of March, 1922, and that the tax shall be paid on or before the 15th day of March, 1922. Your petitioner, however, has secured an extension of sixty days as provided in said Act for the filing of a

return and payment of said tax. Unless the return is made and the tax is paid before the expiration of said sixty days, the amount of said income tax will be doubled, and such doubled tax will be increased by one per cent for each month or fraction of a month from the time the tax was originally due to the date of payment. Said extended period of sixty days will expire, said return and payment of the income tax will be due, and the collection thereof will be undertaken prior to the determination of this cause, unless the tax collecting officers are restrained.

Wherefore, application is made under Section 266 of the Judicial Code for an interlocutory injunction as prayed for in said bill, and this Court is petitioned to call to his assistance to hear and determine this application two other judges, and that the statutory notice of the hearing of this application be given the Governor and the Attorney General of the State of North Carolina and each of the defendants to the said bill, and an order issue requiring the defendants to show cause at the time and place to be fixed by this Court according to law why said interlocutory injunction should not issue as prayed for.

This application is based upon the verified bill of complaint on file herein.

S. R. PRINCE,
Solicitor for Complainant.

Order on Application for Interlocutory Injunction.

Filed April 10, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, et al.

The application for an interlocutory injunction was presented to me this — day of March, 1922; and having read and considered the verified bill filed in this cause, and the application for a hearing for interlocutory injunction under Section 266 of the Judicial Code, and being advised that for the reasons set forth in said application and upon the grounds stated therein and in the verified bill, plaintiff is entitled to have its application heard under Section 266 of the Judicial Code:

It is ordered that the application be filed and a hearing of the application for an interlocutory injunction be had and proceeded with

in accordance with Section 206 of the Judicial Code as amended by Act of Congress Approved March 14, 1913, and such hearing is set down for April 15th, 1922, at the United States Court Rooms in the city of Raleigh, N. C.

It is further ordered, that notice of said hearing, not less than five days, shall be given to the Governor and Attorney General of the State of North Carolina, and to each of the defendants to this suit. And I hereby call to my assistance at said hearing of said application the Honorable Edmund Waddill, Jr., Circuit Judge of this Circuit, and the Honorable James E. Boyd, District Judge of the Western District of N. C.

This April 8, 1922, at Wilson, North Carolina.

H. G. CONNOR,
District Judge.

Extract from the Minutes of the Court.

April 15, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS et al.

Present: The Honorable Henry G. Conner, Judge of the District Court for the Eastern District of North Carolina.

Order.

"It is ordered that this cause be set down for final hearing on its merits on Monday, June 13, 1922, Counsel for Plaintiff and Defendants being in open Court and assenting thereto; application for Interlocutory Injunction being waived by Counsel for Plaintiff."

36 *Answer.*

Filed April 19, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY, Complainant,

v.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, et al.,
Defendants.

Answer.

To the Honorable H. G. Connor, Judge of the District Court of the United States for the Eastern District of North Carolina:

The defendants above named, answering the bill herein, respectfully show the Court that:

1. Article 1 of the bill is admitted.

2. It is admitted that the amount in controversy herein, exclusive of interest and cost, exceeds the sum of \$3,000. But defendants expressly deny that complainant has any equity to enjoin defendants from collecting the income tax attacked by said complainant; that said railroad company will be deprived of any privilege guaranteed and secured to it by the Constitution of the United States and the Fourteenth Amendment thereof; that it will be deprived of its property without due process of law; that it will be denied the equal protection of the law in contravention of the Constitution of the United States and the Fourteenth Amendment thereof, and that the taxes sought to be imposed by virtue and under the authority of the North Carolina statute constitute a direct burden upon interstate commerce, in violation of the commerce clause of the Federal Constitution.

3. It is admitted that the income-tax provision of the Constitution of North Carolina and the whole of Section 3 of Article V of the same are correctly set forth in Article III of the bill.

4. Article IV of the bill is admitted.

5. It is admitted that the portions of the Income Tax Act of 1921, as amended by the Special Session of 1921, quoted in Article V of the bill, are correctly quoted.

6. The first clause of Article VI of the bill is admitted. The complainant's allegation that said act is void as to it, is expressly denied.

(a) The income-tax provision of the Constitution of the State of North Carolina, quoted in Article IV of the bill, authorizes the Legislature to determine what shall be the net income to be taxed thereunder, and expressly prohibits the allowance of any deduction for living expenses. The statute enacted by the General Assembly of 1921, in pursuance of such constitutional authority, Chapters 34 and 35 of the Public Laws of 1921, classifies income-tax payers as follows, providing for each class a different method for ascertaining taxable incomes: first, resident individuals; second, nonresident individuals, Section 200; third, resident corporations; fourth, nonresident corporations, Section 201; fifth, railroads and other public-service corporations having their lines wholly within the State; and sixth, railroads and other public-service corporations having their lines partly within the State and partly without; and the defendants are advised, and so aver, that such classification does not in any way offend against any provision of the State or Federal Constitution. No one of these classes is allowed the same deduction or exemption as those allowed to the other classes, and in each case the distinctions made are made on account of an inherent difference between

the classes themselves. The statute itself (Section 202) provides the method by which the net income of railroads is to be ascertained. It declares that, as to such railroads operating wholly in the State, the net income shall be "the net operating income" as shown by their records, kept in accordance with the standard classification of accounts of the Interstate Commerce Commission. As to railroads, when their business is part within and part without the State, it declares their net income within the State shall be ascertained by taking their gross "operating revenues" within this State, including in their gross "operating revenues" within this State the equal mileage proportion within this State of their interstate business, and deducting from their gross "operating revenues" the proportionate average of "operating expenses," or "operating ratio," for their whole business, as shown by the Interstate Commerce Commission standard classification of accounts. From the sum so found they are allowed to deduct "uncollectible revenue" and taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes, and an equal mileage proportion of car hire, and the balance shall be deemed to be their net income taxable under this act. The method thus provided by the General Assembly for ascertaining the net income of such railroads, as defendants are advised and aver, is both legally and constitutionally a proper one to apply to them, and does not offend against the interstate commerce clause of the Federal Constitution.

(b) That deductions and exemptions are allowed individuals which are not allowed ordinary corporations or railroads, and that deductions are allowed ordinary corporations which are not allowed railroads, in specific terms, arises from the necessity to classify income-tax payers so as to arrive at their net income, and that necessity

arises from differences inherent in the various businesses thus classified. Without such classification, defendants are advised and believe, it would be impossible to levy a fair and just income tax.

Defendants are advised and believe that, in applying the method provided in the act, many deductions are necessarily allowed, besides those specifically set out in Section 202, "uncollectible revenue," and taxes paid in this State for the income year, etc., i. e., wages of employees, salaries of officers, if reasonable in amount, for services actually rendered in producing such income, and others too numerous to incorporate in this answer. A list of them is hereto attached, marked "Exhibit A," and is asked to be taken as part of this answer. It is admitted that interest paid during the tax year on outstanding bonded indebtedness is not one of the deductions allowed to railroads, whereas it is allowed to individuals and business corporations, but many other deductions are allowed to railroads which are not allowed to either individuals or business corporations. See "Exhibit A." Defendants are informed and believe, and so aver, that the method of financing railroads is so wholly different from that of other corporations that they are necessarily in a class to themselves with other public-service corporations, and that a refusal, under such circumstances, to permit a deduction for interest on their bonded indebtedness is justified and is not a discrimination against them. The statute (Section 306, subsection 3) expressly prohibits the deduction of dividends on preferred stock to business corporations.

(c) Section 202 was enacted, as defendants are advised and believe, so as to apply only to the companies described therein when such company is required to keep records according to the standard classification of accounting of the Interstate Commerce Commission. Any public-service company not coming within this designation would pay income tax under other provisions of the act. The process of arriving at the net income earned by railroads having part of their line in the State and part out is necessarily long and intricate. The General Assembly, knowing this, and knowing also that the simplest way of arriving at such a net income was by using as a basis the records required to be kept by the Interstate Commerce Commission, adopted that plan, and declared in Section 202 what should be the net income of such corporations in its application to them. Defendants deny that this classification is either unreasonable or arbitrary, and aver that instead it is based upon an evident distinction in the classes, and is valid and constitutional.

(d) It is admitted that the revenue laws of the State of North Carolina permit counties and other subordinate governmental agencies to levy an ad valorem tax on all property within their territorial limits, whether belonging to individuals, firms, or corporations, or railroads, subject to certain legal and constitutional restrictions. It is admitted that the State levies no ad valorem tax at all upon any of those classes. It does levy an occupation tax upon very many occupations, whether carried on by an individual or corporation, and it does levy a franchise tax upon all corporations, including railroads, and it does levy

an income tax upon all net incomes earned in the State, whether earned by an individual, a corporation, or a railroad. All these taxes, the defendants aver, are levied and collected according to equal and uniform rule, with only allowable and constitutional classification. It is expressly denied that this scheme of taxation, either in general outline or in the detail of its administration, is in any sense a burden upon interstate commerce.

(e) It is denied that the statutes imposing an income tax upon complainant are a violation of the scheme of taxation created and made mandatory by the Constitution of North Carolina. The amendments to the State Constitution, commonly called the taxation amendments, were adopted at the general election of 1920 and became effective January 7, 1921. The defendants are advised and believe that such amendments authorized the General Assembly of the State to adopt the general scheme of taxation which it commenced to put into effect at the Extra Session of August, 1920, and put in full force in the Revenue Act of 1921; that a general scheme of taxation is wholly within the authority of the State, and can only be attacked

41 when the legislation enacted in pursuance thereof, or the administration of such taxing laws, destroys some constitutional right of the complainant; that the refusal of the State to levy an ad valorem tax upon the property of the defendant, while it permits subordinate governmental agencies to levy this tax under the rules, regulations and restrictions contained in the State Constitution, can in no sense, as defendants aver and believe, impair any constitutional right of the complainant; that the State, as defendants are advised and believe, may constitutionally levy a license or franchise tax upon complainant for the privilege of performing its functions in the State; an income tax upon income earned in the State, and also an ad valorem tax upon its property for the benefit of the State; that its refusal to levy the latter tax cannot, as defendants aver, affect the constitutionality of the levy of the franchise and income tax. Defendants particularly deny that there has been any exemption of any class of property from the general burdens of taxation, as alleged in subsection (c) of Article VI of the bill; and defendants aver that the scheme of taxation of the shares in incorporated companies in the hands of the shareholders, as provided in the Revenue and Machinery Acts of 1921, has been in effect in the State for more than twenty years; said shares being taxed at the principal office of the corporation itself.

7. It is true that the Commissioner of Revenue has sent to complainant the form for return of income tax for the calendar year ending December 31, 1921, attached to the bill. It is admitted that he will proceed to collect, in accordance with the machinery of the law, a proper income tax from complainant. It is true that the Commissioner of Revenue may, under Section 504, issue an order, under his hand and official seal, directed to the sheriff of any county of the State, commanding him to levy upon and sell the real and personal property of the taxpayer. The payment of such tax, however, will prevent any sale, and the taxpayer is given an adequate remedy at

law, in Section 7979 of the C. S. of 1919, and in an act of the
 42 Extra Session of 1921, entitled "An act to refund taxes il-
 legally collected and paid into the State treasury."

Defendants expressly deny that the penalties set forth in Section
 600 of the Income Tax Act are excessive, unreasonable, oppressive,
 and inequitable. Those penalties are imposed for wilful or fraudu-
 lent failure to comply with the provisions of the act, and so would
 not be a denial of due process of law to the complainant. The Re-
 venue Commissioner and the Attorney-General are given authority to
 waive or reduce the penalties therein provided for.

Wherefore, having fully answered all the allegations of the bill
 herein, the defendants pray judgment:

1. That the bill be dismissed.
2. For cost of this action.
3. For such other and further relief as to the Court may seem just.

JAMES S. MANNING,
Attorney-General of North Carolina,
 FRANK NASH,

Assistant Attorney-General of North Carolina,
Solicitors for Defendants.

GEO. H. BROWN,
 WM. P. BYNUM,
 LOCKE CRAIG,
 THOS. D. WARREN,
 S. S. ALDERMAN,
Of Counsel.

43 A. D. Watts, one of the defendants, being duly sworn, says
 that he is State Commissioner of Revenue; that he has read
 the foregoing answer and knows the contents thereof; that the same
 is true, of his own knowledge, except as to matters therein stated on
 information and belief, and as to those matters he believes it to be
 true.

A. D. WATTS.

Sworn and subscribed to before me, this April 19, 1922.

EDWARD SEAWELL,
Deputy Clerk Supreme Court.

44 EXHIBIT A.

1. Maintenance of Way and Structures:

Superintendence; roadway maintenance—yard; roadway mainte-
 nance—other; tunnels and subways—other; bridges, trestles and cul-
 verts—yard; bridges, trestles and culverts—other; ties—yard; ties—
 other; rails—yard; rails—other; other track material—yard; other
 track material—other; ballast—yard; ballast—other; track laying

and surfacing—yard; track laying and surfacing—other; right of way fences—yard; right of way—other; crossings and signs—yard; crossings and signs—other; station and office buildings; roadway buildings; water stations; fuel stations; shops and engine houses; wharves and docks; telegraph and telephone lines; signals and interlockers; power plant buildings; miscellaneous structures; paving; roadway machines; small tools and supplies; removing snow, ice and sand; assessments for public improvements; injuries to persons; insurance; stationery and printing; other expenses; maintaining joint tracks, yards, and other facilities—Dr.; maintaining joint tracks, yards, and other facilities—Cr.

2. Maintenance of Equipment:

Superintendence; shop machinery; power plant machinery; steam locomotives—repairs; steam locomotives—depreciation; steam locomotives—retirements; freight-train cars—repairs; freight-train cars—depreciation; freight-train cars—retirements; passenger-train cars—repairs; passenger-train cars—depreciation; passenger-train cars—retirements; floating equipment—repairs; floating equipment—depreciation; work equipment—repairs; work equipment—depreciation; work equipment—retirements; injuries to persons; insurance; stationery and printing; maintaining joint equipment at terminals—Dr.; maintaining joint equipment at terminals—Cr.; other expenses.

45 3. Traffic:

Superintendents; outside agencies; advertising; traffic associations; industrial and immigration bureaus; insurance; stationery and printing.

4. Transportation—Rail Line:

Superintendence; dispatching trains; station employees; weighing, inspection, and demurrage bureaus; station supplies and expenses; yardmasters and yard clerks; yard conductors and brakemen; yard switch and signal tenders; yard enginemen; fuel for yard locomotives; water for yard locomotives; lubricants for yard locomotives; other supplies for yard locomotives; engine-house expenses—yard; yard supplies and expenses; train enginemen; train motormen; fuel for train locomotives; water for train locomotives; lubricants for train locomotives; other supplies for train locomotives; engine-house expenses—train; trainmen; train supplies and expenses; signal and interlocker operation; crossing protection; drawbridge operation; telegraph and telephone operation; operating floating equipment; stationery and printing; other expenses; insurance; clearing wrecks; damage to property; damage to livestock on right of way; loss and damage—freight; loss and damage—baggage; injuries to persons; operating joint yards and terminals—Dr.; operating joint yards and terminals—Cr.; operating joint tracks and facilities—Dr.; operating joint track and facilities—Cr.

5. Transportation—Water Line.

6. Miscellaneous Operations:

Dining and buffet service; hotels and restaurants; producing power sold; other miscellaneous operations.

7. General:

Salaries and expenses of general officers; salaries and expenses of clerks and attendants; general office supplies and expenses; law expenses; insurance; pensions; stationery and printing; valuation expenses; other expenses; general joint facilities—Dr.; general joint facilities—Cr.

46

Affidavit of A. R. Turnbull.

Filed May 23, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY.

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.

A. R. Turnbull, being first duly sworn, deposes and says:

1. That he is President of the Rowland Lumber Company.
2. Rowland Lumber Company is a corporation duly organized and existing under the laws of the State of North Carolina, the principal business of the said company is the manufacture of lumber.
3. That it operates a large mill in North Carolina, located at Newbern, and has under lease a line of railroad extending from Clarks Junction, a point on the Atlantic & North Carolina Railroad, westwardly to and beyond New River and thence to Chinquapin, and a few miles beyond, where it connects with a line of railroad owned by Rowland Lumber Company, which extends to Kenansville, where it connects with a line of railroad owned by Atlantic & Carolina Railroad Company.
4. The principal business of the said railroad running from Kenansville to Clarks Junction, through Chinquapin is the transportation of logs and lumber for the owner of such railroad.
5. The Corporation Commission of North Carolina, acting under the power vested in it by section 3413 Consolidated Statutes of North Carolina, has granted to Rowland Lumber Company authority to transport commodities of certain kinds and character other than

owned by the said Rowland Lumber Company over that part of the said line of railroad between Kenansville and Chinguapin and to charge therefor a scale of rates fixed and established by the Corporation Commission of North Carolina.

47 6. Rowland Lumber Company does transport for others than itself commodities of the kind and character authorized by said authority to be transported and charges therefor the scale of rates authorized by the Corporation Commission.

7. That the Rowland Lumber Company is not engaged in interstate commerce and has never filed any tariffs with the Interstate Commerce Commission, and has not been authorized to engage in interstate commerce, and is prohibited under the law from so doing until it has filed tariffs with the Interstate Commerce Commission as required by the Interstate Commerce Act.

8. That during the calendar year 1921, which is the income tax year for 1921 in the state of North Carolina, Rowland Lumber Company paid rent for the line of railroad operated by it as aforesaid and also paid other rents for properties used in its said business and to which it had no equity except its leasehold, and also paid sums as interest for money borrowed and used in its business.

9. Affiant is informed and believes that Rowland Lumber Company is, under the income tax law of North Carolina, schedule D, of Chapter 34, entitled to deduct the amounts so paid as interest and rent, together with other deductions allowed by said schedule from its gross income, in order to arrive at its net income subject to tax under the said tax laws of North Carolina.

10. That the said railroad is of standard gauge and can and does receive cars from other lines of railroad, which it transports to destination on its own line.

A. R. TURNBULL.

Sworn and subscribed to before me this 20th day of May, 1922.

[SEAL.]

J. B. DEY, JR.,
Notary Public.

Com. expires Sept. 18, 1923.

48

Affidavit of Nathan O'Berry.

Filed May 23, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue *or* North Carolina, et al.,
Defendants.

Nathan O'Berry, being first duly sworn, deposes and says:

1. That he is a citizen and resident of the State of North Carolina and County of Wayne, that he is President of Enterprise-Whiteville Lumber Company.

2. That said company is an industrial corporation engaged in operating lumber mills located respectively at Whiteville and Mt. Olive, North Carolina.

3. That said company, as a part of its business constructed a line of railroad extending from Whiteville, N. C., to Butlers, N. C., a distance of about 27 miles, and also constructed a line of railroad extending from Mt. Olive, N. C., to New Camp, N. C., a distance of about 18 miles.

4. That said railroads were established and maintained solely by the owner of the lands upon which the said roads were constructed and the principal business of said railroad is the transportation of logs, lumber and other articles of the owners of said railroad.

5. Acting under the provisions of section 3413 of the Consolidated Statutes of North Carolina, the said corporation applied to the Corporation Commission of North Carolina for authority to said corporation to transport between the termini of said two lines of railroad, commodities other than that owned by the said lumber company, and for authority to charge therefor reasonable rates to be approved by said corporation.

6. The Corporation Commission, under the powers vested in it under said section 3413 of the Consolidated Statutes of North Carolina, duly authorized the said corporation to act as a common carrier between the termini of its said two lines of railroad and established a scale of rates which said corporation might charge for the

transportation of the kind and character of commodities which it was authorized to transport for others for such services.

7. That the said Corporation does not have any Tariff filed with Interstate Commerce Commission, and is not authorized to and does not engage in the transportation of freight or passengers in interstate commerce, or between any points other than those on its own line. That the said corporation, during the year 1921, paid interest on account of money borrowed, that the said corporation in making its income tax returns to the Commissioner of Revenue of the State of North Carolina, deducted from its gross income the interest so paid in order to arrive at its net income, this deduction being made in addition to the other deductions allowed under section 306, schedule D of the Revenue Act of North Carolina.

8. This affiant is informed and believes that it was entirely proper under the laws of North Carolina for said corporation to deduct the interest paid during the year 1921 from its gross income, together with the other deductions allowed in section 306 of schedule D, Revenue Act of North Carolina from its gross income in order to ascertain the net income subject to tax.

NATHAN O'BERRY.

Sworn and subscribed to before me this 17th day of May, 1922.

[SEAL.]

C. W. BRINKLEY,
Notary Public.

My Commission expires January 24th, 1924.

50

Affidavit of C. D. Bradham.

Filed May 25, 1922.

In the District Court of the United States for the Eastern District
of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue, et al.

C. D. Bradham, being first duly sworn, deposes and says that he is President of the Atlantic & North Carolina Railroad Company; that prior to the year 1921, the Atlantic & North Carolina Railroad Company leased to the Howland Improvement Company its line of railroad, extending from Morehead City to Goldsboro, North Carolina.

That the Norfolk Southern Railroad Company is the successor in title to the said leasehold interest granted by said lease and during the year 1921 was in possession of said line of railroad under said

lease and used the same exclusively and conducted and carried on the business of a common carrier over said line of railroad.

That during the said year 1921, Norfolk Southern Railroad Company paid the Atlantic & North Carolina Railroad Company the amount of rent required by said lease to be paid for the continued use of said property in the trade or business of Norfolk Southern Railroad Company; that the payment of the said rent was a condition precedent to the continued use of the said property by the Norfolk Southern Railroad Company in its business.

That the Norfolk Southern Railroad Company has not taken title to the said property, was not taking title thereto, and has no equity in the property owned by the Atlantic & North Carolina Railroad company.

51 That under the terms of the said lease, Norfolk Southern Railroad Company, as Lessee, is required to pay any Income Tax levied upon the income of the Atlantic & North Carolina Railroad Company derived from or under said lease.

That the amount of money received from Norfolk Southern Railroad Company as rent for the use of said property is substantially the entire income of the Atlantic & North Carolina Railroad Company.

C. D. BRADHAM.

Subscribed and sworn to before me this 17th day of May 1922.

[SEAL.]

H. J. CARPENTER,

Notary Public.

My commission expires on the 7th day of Oct. 1922.

52 *Affidavit of O. S. Thompson.*

Filed June 5, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY et als., Plaintiffs,

vs.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, et als., Defendants.

Railroad Income Tax Suits.

Affidavit of O. S. Thompson.

O. S. Thompson being duly sworn, deposes and says:

Since 1906 affiant has been connected with the Corporation Commission of North Carolina, and with the State Department of

Revenue since its creation in 1921. The Corporation Commission, in addition to its duties as such, was by statute created the State Tax Commission with the duties of administering the tax laws of the State. Affiant's position with the said State Tax Commission was that of Tax Clerk, and as such his duties were the general supervision of the details of the administration of the tax laws of the State. While Tax Clerk of the State Tax Commission affiant had extensive experience with the Standard Classification of Accounts of the Interstate Commerce Commission in connection with preparing the reports of the Corporation Commission based in part on the said Standard Classification.

Affiant is now Deputy Commissioner of Revenue of North Carolina and acting Chief Clerk of the State Department of Revenue and his duties as such are similar to those formerly performed by him as Tax Clerk of said State Tax Commission. Prior to 1906 affiant served as an employee of the Southern Railway Company as clerk handling taxation matters.

In his capacity as Deputy Commissioner of Revenue and acting Chief Clerk of the State Department of Revenue the affiant is familiar with the requirements of that Department as to returns for taxation by taxpayers, with the forms of such returns, and is custodian of the records of the State Department of Revenue. Affiant is familiar with the administration of the tax laws of the State by the State Department.

The State Department of Revenue has only one blank for returns for income tax which is sent out to and used by all railroad corporations engaged in the operation of railroads. This is known as Form 7, and is attached to this affidavit, marked Exhibit A. This form is required by the State Department of Revenue to be filled out by all railroads doing business in the State of North Carolina, whether operating partly within or partly without the State, whether operating wholly within the State but as common carriers with interstate railroads, or whether doing wholly intrastate business. This Form 7 requires a report by all such railroad corporations of their net income as defined by the Income Tax Act of 1921, under the provisions of section 202 of that Act, and based upon and according to the Standard Classification of Accounts of the Interstate Commerce Commission.

53 The State Department of Revenue requires all such railroad corporations to make return for income taxation upon this form and ascertain the net income of such railroads for taxation without discrimination according to the provisions of the said section 202.

Affiant has read the affidavits of Nathan O'Berry, President of the Enterprise-Whiteville Lumber Company, and of Mr. A. B. Turnbull, President of the Rowland Lumber Company, filed in their suits by the Norfolk and Southern Railway Company. It is true that these lumber companies and other similar companies are not classed as railroads by the State Department of Revenue, are not treated as railroads for income tax purposes or for any other purpose whatsoever, and are not required to make returns for income tax

according to the Standard Classification of Accounts and upon Form 7, but are required to and do make return for income tax on Form 3, which is the Form required by the Department for corporations in general other than the railroads and other public service corporations taxed according to section 202. In fact, these lumber companies and other similar companies are not railroads and are not public-service corporations. As is stated in the said affidavit by the presidents, their principal business is the lumber business, only such transportation as they carry on is principally the transportation of their own property as incident to the lumber business. Under section 3413, Consolidated Statutes, the Corporation Commission has the power to grant to such companies authority to transport certain commodities other than their own property, subject to the supervision of the Commission, but the affiant is informed and believes that the purpose of such provision is simply to allow such companies to accommodate immediate communities in which they operate; that when such authority is granted to and exercised by such companies they do not engage in the business of transportation as common carriers for others for profit, but only as the purely incidental service of accommodation; that in any such case the transportation of property of others by such a corporation is wholly negligible in amount and purely incidental to the principal business of the corporation, which is the lumber business.

Affiant states, therefore, as a matter of his own knowledge, that the Income Tax Act of 1921, as administered by the State Department of Revenue, applies exactly in the same way and without any discrimination whatsoever to all railroad corporations doing any business in the State engaged in railroad operation, whether foreign or domestic, whether operating partly within and partly without the State, or wholly within the State. All are required to make return for income tax according to the Standard Classification of Accounts and under section 202, and exactly the same deductions are allowed to all, without discrimination.

Not only is the entire class of railroads subjected to income taxation under the provisions of section 202 with ascertainment of net income upon the basis of the Standard Classification of Accounts, but the same is true as to the broader class of all strictly public service corporations, not including such lumber companies as are above referred to and which the affiant is informed and believes are not public-service corporations at all.

The State Department of Revenue has one form for income tax return for all public service corporations other than railroads, Form 8, a copy of which is attached hereto and marked Exhibit B, and which form is substantially identical with Form 7 upon which railroads are required to make return. The Department of Revenue requires, therefore, not only of railroads, but of all other public service corporations, that they file returns for income tax upon the basis of the Standard Classification of Accounts, under the provisions of section 202.

Affiant has read the affidavit of Mr. J. H. Bridges, President of the Henderson Water Company, in which Mr. Bridges

states that the Henderson Water Company is not required to and does not keep its records according to the Standard Classification of Accounting, and that it did not make return for income taxation according to the said classification under the provisions of section 202. Affiant states that the returns for income taxation in the office of the Department of Revenue for the year ending December 31, 1921, have not yet been audited and checked for correctness. If what Mr. Bridges says with reference to the return made by the Company is true, his company will be required to amend its return and to file a return on Form 8 according to the said Standard Classification and under the provisions of section 202. As the Department of Revenue interprets the Income Tax Act, the Henderson Water Company, as well as all other public service corporations, are required by it to make return for income tax in accordance with the accounting system of the Standard Classification. The auditing of income tax returns for the said year is in progress at this time, but has not been completed, and, with reference to railroads and other public-service corporations, has been held over pending decision in these suits as to the validity of the income tax as to such corporations, in view of the plaintiff's attack upon the income tax law as applied to them.

O. S. THOMPSON,

Affiant.

Subscribed and sworn before me this the 5th day of June, 1922.

[SEAL.]

W. H. PITTMAN,

Notary Public.

My commission expires July 29, 1922.

55

Affidavit of A. J. Maxwell.

Filed June 5th, 1922.

In Equity.

#449.

In the District Court of the United States for the Eastern District of
North Carolina.

SOUTHERN RAILWAY Co. et als., Plaintiffs,

v.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, et als.
Defendants.

Railroad Income Tax Suits.

Affidavit of A. J. Maxwell.

A. J. Maxwell, being first duly sworn, deposes and says:
Affiant is a member of the State Corporation Commission of North Carolina and has been such since 1910, during which time the said

commission was, until 1921, also the State Tax Commission with the duties and functions with reference to administering the tax laws of the State imposed upon the newly created State Department of Revenue by the statute of 1921. In such position the affiant has been directly connected in an official capacity with the administration of the tax laws of the State until the creation of the State Department of Revenue to replace the State Tax Commission as such. In such capacity the affiant was in constant consultation with the finance committees of the General Assembly at the time of the drafting of the Income Tax Act of 1921. In such capacity the affiant has had extensive experience familiarizing him with the Standard Classification of Accounts of the Interstate Commerce Commission, has made a special and comparative study of the taxation systems of other states and of the subject of taxation.

When the enactment of the Income Tax Act of 1921 was under consideration in the finance committees of the General Assembly, the railroads were heard on the matter and they made the same objection to the provisions of Section 202 that they are now making in these suits. They argued that the application of those provisions to them would not lead to an ascertainment of their net income because certain items, notably interest on bonded indebtedness and rentals paid for leased properties, were not included in the operating expenses in the said Standard Classification, whereas as to individuals and to corporations other than public service corporations deductions were allowed under general terms of the Act which the railroads alleged to be analogous to such interest and rentals.

The legislative committees considered these objections fully and carefully. In enacting the Act in the terms, finally adopted, the General Assembly considered certain well known facts with reference to the method in which railroad corporations are financed. It is a general rule that railroads are financed almost entirely by bond issues, their stock being issued largely incidentally and sometimes even distributed as bonus with the bonds. The rule is that the capital finances are procured by bond issues. This being the case, interest paid on the bonds is properly considered not as a current, operating, or business expense, but as a capital expense. The legislature considered that "net income" as generally understood and as judicially defined means the business revenues less all those expenses incurred in the earning of such revenues, but not deducting any expense on account of or to provide for capital or permanent investment in the business. It was manifest, therefore, that if interest on bonds should be allowed as a deduction in arriving at net income of railroads, this would be the allowing of a capital expense not an operating or business expense, and the result obtained after making such deduction in addition to operating and business expenses would not be the net income of the railroad but less.

With reference to the matters of rentals paid for the lines leased and operated by the railroads, the committees considered the well-known facts that these leases are usually for long terms and with numerous collateral obligations which make them amount practically

to purchases of the lessor road's properties by the lessee, and that, this being true, the consideration paid for such long leases of property used fully as if the property of the lessee in its business is really not an operating expense but is by clear analogy and in practical effect a capital expense. If these expenses were allowed as deductions to the plaintiffs, the result would be that they would have no income subject to tax until they had earned enough to provide, not only for all business and operating expenses, but also for all capital expenses and had paid all interest on their bonds; in other words, it would amount to nothing more than a tax on the savings of railroads, which would render the tax utterly incommensurate with that imposed as income tax on individuals and other ordinary corporations.

Affiant states it as his opinion that the Income Tax Act as applied to railroads and other public service corporations under the provisions of Sec. 202 results in a strictly fair and just tax upon their net income, entirely commensurate in scope and burden with the tax imposed on other corporations, and individuals, except that perhaps, in view of the fact that individuals are allowed no deduction whatever for living and family expenses, which expenses are analogous to many items allowed all corporations as deductions, the tax bears relatively more heavily on individuals than on corporations by reason of the constitutional inhibition against allowing such deductions to individuals.

As to the contention of the plaintiffs that it is arbitrary classification and discrimination to base a classification on the question whether the taxpayer is required to keep his accounts in accordance with the Standard Classification, the affiant is advised and believes, and so states, that so long as all railroads are placed within the class and are treated alike without discrimination, the classification is reasonable and not arbitrary, because the distinction of being railroads and not other corporations is a practical and reasonable basis of distinction and classification. Affiant asserts further that all railroads are taxed alike under the Income Tax Act of 1921. All are required to make return for taxation on Income Tax Blank Form 7, according to the Standard Classification of Accounts; and that the class is even broader than that of railroads, including all other public service corporations, these being required to make return on Form 8, according to the same Standard Classification, as sworn to in the affidavit of O. S. Thompson filed by the defendants herein.

When railroads keep the Standard Classification of Accounts, under Federal or State requirement, the only practical method of requiring return for income tax to be made is according to such classification of accounts, and for the State to require different accounting, or to require return according to another system of accounting, would conflict practically with the power of the Interstate Commerce Commission to prescribe uniform classification of accounts.

57 The State of North Carolina has not undertaken to prescribe any system of accounting for the plaintiffs or other railroads in conflict with that already required to be kept by the Interstate Commerce Commission, but has adopted that system

the best and most practical basis for the calculation of net incomes for taxation.

A. J. MAXWELL,
Affiant.

Subscribed and sworn to before me this 5th day of June, 1922.
[SEAL.]

W. H. PITTMAN,
Notary Public.

My commission expires July 29, 1922.

58

Affidavit of R. O. Self.

Filed June 5, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY et als., Plaintiffs,

vs.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, et als.,
Defendants.

Railroad Income Tax Suits.

Affidavit of R. O. Self.

R. O. Self being duly sworn, deposes and says:

Affiant is the clerk of the State Corporation Commission of North Carolina, has been such since the first of September 1919, and as such is the custodian of the records of the said Commission and is thoroughly familiar with the administering by the Commission of its duties and powers given it by statute. He is thoroughly familiar with the classification made by the Corporation Commission of corporations subject to its supervision.

Affiant has read the affidavit of Mr. A. R. Turnbull, President of the Rowland Lumber Company, which affidavit is filed by the Norfolk Southern Railroad Company in these suits, and affiant is familiar with contents thereof. He has also read and is familiar with the contents of the affidavit of Mr. Nathan O'Berry, President of the Enterprise-Whiteville Lumber Company, filed by the said plaintiff in these suits.

The said Rowland Lumber Company, and the said Enterprise-Whiteville Lumber Company do what is known as a limited transportation business, and are authorized by the Commission to carry in their logging roads certain limited commodities other than their

own property. These corporations are not railroad Corporations, but are lumbering corporations. Their lines of tramway, or railroad, are constructed by them for the purpose of hauling logs and lumber and operating their lumber business. When such roads are established

59 there are frequent demands by the communities through which they run, for them to transport other commodities for the convenience and accommodation of the inhabitants of those communities. Under Section 3413, Consolidated Statutes, the Corporation Commission has the power to, and in proper cases does, grant authority to such logging or lumber companies to carry for hire over their logging, or tramway, roads commodities of others within certain limitations.

These corporations are not classed, considered, or treated by the Corporation Commission as railroads, but they are subjected to the supervision of the Commission, chiefly to prevent discrimination as to the very limited carrier service which they are allowed to perform. They are not classed as common carriers, in the same class as railroads such as the plaintiffs in these suits.

As to the Rowland Lumber Company, it entered into the business referred to in the affidavit of Mr. Turnbull not for profit, but purely for the accommodation of the community, as the following quotations from letters and documents will show:

Letter from Mr. A. R. Turnbull, President, Rowland Lumber Company to W. G. Womble, Rate Clerk, State Corporation Commission, Raleigh, N. C., March 22, 1918:

"It is true that we have been handling fertilizer over the west end of our road for the benefit of the people located in that territory. This is merely an accommodation to them, and is of no benefit to us; * * * If these people do not care for this accommodation it will certainly be a great pleasure for us, under present circumstances to discontinue this hauling of freight for them, as it is done absolutely at cost to us on the present basis."

Letter from Stevens & Beasley, Attorneys for the Rowland Lumber Company, to the North Carolina Corporation Commission, dated March 27, 1918. This letter after referring to complaints made by certain citizens of Faison, N. C., against the Rowland Lumber Company for alleged excessive charges for hauling fertilizer says:

"The Rowland Lumber Company is not operating a logging business, over its road, this year, in Sampson County to any extent but is confining its operations to its log road in Duplin. It has not even determined to open up its road in Sampson County for the carrying of freight as charged, but was simply coming to the rescue of the farmers of Sampson County, and aiding them, as all good citizens should do, in making food for fighting Germany. For all the winter the roads in that section have been almost impassible with an empty vehicle and had the farmers, many of them 15 miles from the railroad, been permitted by the roads to have hauled at all the cost would have been enormous, from \$3 to \$

60

per ton and in this emergency the Rowland Lumber Company has been helping them out at great inconvenience to itself and even a loss. Labor conditions are such the cost of operating is so high that no one except a man like Mr. Turnbull would have undertaken to deliver the fertilizer to these people and he regrets that they have been so shortsighted as to kick, for it might have been possible for the road to have been developed into a public carrier under his generous impulses and public spirit. In building the Atlantic & Carolina Railroad, he has done more for Duplin County than any other one man."

The authority granted to the Rowland Lumber Company, as aforesaid, was granted pursuant to petition filed by the Rowland Lumber Company with the Corporation Commission, copy of which is attached hereto and marked Exhibit "A," and which petition shows that it was made purely to accommodate citizens, who requested such service of the Rowland Lumber Company.

On the 27th of February, 1922, Mr. A. R. Turnbull, President of the Rowland Lumber Company, addressed another letter to Mr. W. G. Womble, Rate Clerk, Corporation Commission, in which he said:

"As you will understand we are not operating on piece of road west of Bowden, but are simply hauling fertilizer, etc., for the accommodation of people in that territory. We would be money ahead by discontinuing this service, and will do so if you deem it necessary, but in the meantime, we will do the best we can to give them all the service possible. We have left one locomotive at Bowden to attend to this business and hope to give them better service this year than we have in the past. On the two points, Newton Grove and Eureka Church, however, there will be some delay, and we have notified all shippers whom we know that we do not care to handle this business except in that way."

There is attached hereto and marked Exhibit "B," a schedule of the rates of the Enterprise-Whiteville Lumber Company over its logging road, effective December 1, 1920, as filed with the Corporation Commission, which schedule shows the limitation as to the commodities carried and allowed to be carried by this road.

These logging roads and others similar to them are not classed as railroads and as full common carriers by the Corporation Commission for the reasons above shown, for the reason that their business of carriage of property of others is purely incidental to their business of logging and manufacturing lumber, and is negligible in amount, and for the reason that they maintain no regular schedule of trains, but run simply when there is particular demand for a particular carriage.

R. O. SELF,
Affiant.

Subscribed and sworn to before me this 5th day of June, 1922.

[SEAL.]

W. H. PITTMAN,
Notary Public.

My commission expires July 29, 1922.

EXHIBIT "A."

Rowland Lumber Company.

Norfolk, Va., May 21, 1918.

To the Corporation Commission of North Carolina:

The Rowland Lumber Company respectfully sheweth to the Corporation Commission of North Carolina:

1. That it is a corporation incorporated under the laws of the State of North Carolina, authorized to engage in the Lumber business. In the operation of its timber it has purchased, and caused to be constructed, for logging purposes, a line of railroad running from Bowdens and Warsaw, on the Atlantic Coast Line Railroad, in Duplin County, North Carolina, in a westerly direction for about twenty miles toward Newton Grove.

2. Your petitioner has been, and is continually being, requested by the citizens living along the line of this road to transport freight for them and others; your petitioner is willing to accommodate such parties under present conditions, provided it can do so lawfully.

3. Under Revisal of 1905, Sec. 2598, as amended by Chapter 160 Laws of 1911, your Honorable Body is empowered to authorize this company to transport commodities, and to charge therefor reasonable rates, in addition to the transportation of its own commodities:

Wherefore, your petitioner respectfully prays, that your Honorable Body authorize your petitioner to transport over its logging road, as freight, commodities in carload lots, but excluding lumber and logs, purchased and used along the line of said road, and to make charges therefor; and that this authority be continued from year to year until your petitioner shall give to this Honorable Body necessary notice of its intention to discontinue said service.

Respectfully submitted,

(S.) ROWLAND LUMBER COMPANY,
By A. R. TURNBULL,
President and General Mgr.

EXHIBIT "B."

Rates of Enterprise Lumber Company Railroad.

Effective December 1, 1920.

Fruit and vegetables, per crate.....	20	20	25	25	25
Fruits and vegetables, per car.....	1500	1650	2000	2250	2500
Empty Crates or Barrels, " ".....	1500	1650	2000	2250	2500
Ditto each.....	10	10	12½	15	15
Fertilizers, 20 Tons Maximum.....	2500	2600	3250	3500	4000
Fertilizers from 10 to 20 tons, per ton minimum 1,500 per car.....	150	175	200	225	275
L. C. L., per ton.....	300	300	350	400	450
Cotton Seed and Hulls.....	2000	2200	2700	3000	3300
L. C. L., per ton.....	200	250	325	375	400
Holly, Lime and Flour in carload.....	2000	2200	2600	2800	3000
Wood—Minimum 10 cords, per c.....	100	100	110	125	150
Cotton, per bale.....	150	150	150	175	175
Furniture, per 100 pounds.....	25	27	30	30	35
Chickens and eggs, per crate.....	30	20	30	30	30
Mdsc. not classed, per 100.....	20	20	25	25	30
Brick, minimum 10 per m.....	300	300	300	300	350

All freight is to be loaded and unloaded at expense and risk of shipper. We will not accept any freight either carload or L. C. L. from or to any point except the following:

Oliver's Siding.....	3
Taylor's Siding.....	3½
Loftin's Siding.....	3½
King's Crossing.....	5½
Dobson's Crossing.....	7¼
Hill's or Cherry's Siding.....	9½
Scott's Store.....	12
Brown's Camp or Snow Hill.....	13
Woodland Siding C. L. only.....	16
Kornegay's Bridge " ".....	17

All cars have to — unloaded on the same day they are placed, or demurrage will be charged. No freight will be shipped collect. Package freight will be carried out only on Fridays and if placed at warehouse on any day previous to Thursday it will be held by this Company at the shipper's risk. Carload shipments will be taken out any day in the week.

ENTERPRISE LUMBER COMPANY.
THOMAS O'BERRY, *General Mgr.*

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Affidavit of J. H. Bridgers.

Filed June 20, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, and
Others, Defendants.

J. H. Bridgers, being duly sworn, says: That he is President of Henderson Water Company, a corporation incorporated under the laws of the State of North Carolina, and engaged in the business of supplying water to the public in the town of Henderson, N. C.; that the said corporation is engaged in public service. That the said corporation is not required to and does not keep its records according to the standard classification of accounting of the Interstate Commerce Commission. That after making the deductions allowed it under the Income Tax Act of North Carolina of 1921, the said company has no taxable income. That there is attached to this affidavit and made a part hereof a duplicate of the income tax return filed by the Henderson Water Company with the Commissioner of Revenue of North

Carolina, as required by the Income Tax Act of North Carolina of 1921, upon which said return it appears that the said company after making the deductions allowed corporations under the provisions of the said Income Tax Act, the Henderson Water Company has no taxable income. That there is also attached hereto and made a part of this affidavit a form for income tax return by corporations designated in Section 202 of the Income Tax Act, which has been filled out from the books of the Henderson Water Company and which correctly shows the amount of taxable income upon which the said company would be required to pay the income tax if it came within the corporations designated by said Section 202 and was required to keep its accounts according to the standard classification of accounting of the Interstate Commerce Commission, and from which it appears that said corporation would be required to pay an income tax of \$167.23, if its income taxable under the law were required to be determined on the basis of said return.

J. H. BRIDGERS.

Subscribed and sworn to before me this 14 day of March, 1922.

J. A. SCOTT,
Notary Public.

My commission expires 2 day of May, 1922.

EXHIBIT "A."

Form 8.

State Department of Revenue.

Public-service Corporation Income Tax Return Other Than Railroads.

For Calendar Year Ending December 31, 1921.

Name and kind of business Henderson Water Company.
Business address, Henderson.

We, the undersigned, president and treasurer of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return, including the accompanying schedules and statements, has been examined by him and is, to the best of his knowledge and belief, a true and complete return made in good faith, for the taxable period as stated, pursuant to the Revenue Act for 1921 and the Regulations issued under authority thereof.

President.

Treasurer.

Sworn to and subscribed before me, this — day of —, 1922.

(Official capacity.)

Operating Revenues, in this State, including mileage proportion of interstate business as per standard Classification of Accounts of Interstate Commerce Commission	\$32,101.83
Operation Expenses, as per standard Classification of Accounts of Interstate Commerce Commission	26,079.00
Net operating revenue	\$6,022.00
All other income .....	.....
Total income	\$6,022.00
Less taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes	771.00
Net taxable income	\$5,241.00
Tax @ 3%	\$167.23

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Railroads and public-service corporations; basis of ascertaining Net Income.—The basis of ascertaining the net income of every corporation engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, shall be the "net operating income" of such corporations as shown by their records kept in accordance with that standard classification of accounts when their business is wholly within this State, and when their business is in part within and in part without the State their net income within this State shall be ascertained by taking their *gross income within this State shall be ascertained by taking their gross "operating revenues" within this State the equal mileage proportion within this State of their interstate business and deducting from their gross "operating revenues" the proportionate average of "operating expenses," or "operating ratio," for their whole business, as shown by the Interstate Commerce Commission standard classification of accounts.* From the net operating income thus ascertained shall be deducted "uncollectible revenue," and taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes, and the balance shall be deemed to be their net income taxable under this act.

Car Hire Considered.—In determining the taxable income of a corporation engaged in the business of operating a railroad under the preceding section, in the case of a railroad located entirely within this State, the net operating income shall be increased or decreased to the extent of any credit or debit balance received or paid, as the case may be, on account of car hire; and when any railroad is located partly within and partly without this State, then said net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid, as the case may be, on account of car hire.

EXHIBIT "B."

Form 3.

State Department of Revenue.

Corporation Income Tax Return.

For Calendar Year Ended December 31, 1921.

(Make Affidavit on This Page for Either Blank.)

Name and kind of business, Henderson Water Company—Public Water Supply.
Business address, Henderson, N. C.

We, the undersigned, president and treasurer of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return, including the accompanying schedules and statements, has been examined by him and is, to the best of his knowledge and belief, a true and complete return made in good faith, for the taxable period as stated, pursuant to the Revenue Act for 1921 and the Regulations issued under authority thereof.

J. H. BRIDGERS,
President.
J. H. BRIDGERS,
Treasurer.

Sworn to and subscribed before me, this 10 day of Mar., 1922.

_____,
(Official capacity.)

Corporation Income Tax Return.—Continued.

What was the net income for the calendar year 1921 returned to the U. S. Government before taking off any exemption allowed by the Federal law or State income tax	\$	None.
Bad debts charged off in Federal return and not deductible in this return	\$	None.

Total	\$
-------------	----	-------

Deduction.

Dividends not taxable by State, included in Federal return	\$
--	----	-------

Net income under State law, all of which is taxable	\$
---	----	-------

Tax at 3 per cent	\$	None.
-------------------------	----	-------

If Above Form Is Used, It Is Not Necessary to Fill Out This Form.

Gross Income.

1. Gross sales less returns and allowances .....	\$	.....
Plus inventory close of year .....	\$	.....
2. Less cost of raw materials .....	\$	.....
.....	
.....	
.....	
.....	
Wages and labor .....		.....

*Total raw materials, wages and labor

Plus inventory beginning year.....	\$.....	
Gross income from operation.....		\$32,101.83
3. Gross income from operations other than trading or manufacturing.....		
4. Taxable interest received from all sources.....	\$.....	
5. Rentals.....	.....
6. Royalties.....	.....
7. Income received from partnership.....	.....
8. Total dividends received from foreign corporations, no part of which corporation's income is subject to income tax under the State law. Attach statement showing names of corporations and amount received from each.....	.....
9. Total dividends received from foreign corporations, part of which corporation's income is subject to income tax under the State law. Attach statement showing names of corporations and amount received from each.....	.....
10. Gross income from all other sources subject to tax.....	.....
11. Total income, 3 to 10.....	
12. Total gross income, 1 to 11.....	\$.....

Corporation Income Tax Return.—Continued.

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Deductions.

1. All the ordinary and necessary expenses paid during the income year in carrying on any trade or business	\$.....
2. Reasonable compensation of officers.....	.....
3. Rentals or other payments required to be made as a condition of the continued use or possession, for the purpose of the trade or property to which the taxpayer has not taken, or is not taking title, or in which he has no equity.....	.....
4. All interest paid during the income year on indebtedness, except interest on obligations contracted for the purchase of nontaxable securities. Dividends on preferred stock shall not be deducted as interest.....	.....
5. Taxes for the income year, except taxes on income and war profits and excess profits taxes, inheritance taxes, and taxes assessed for local benefit of a kind tending to increase the value of the property assessed.....	.....
6. Dividends from stock in any corporation the income from which shall have been assessed and the tax on such income paid by the corporation under the provisions of this act: Provided, that when only part of the income of any corporation shall have been assessed under this act only a corresponding part of the dividends received therefrom shall be deducted. Attach statement of such dividends.....	.....
7. Losses sustained during the income year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit.....	.....
8. Debts ascertained to be worthless and charged off within the taxable year if the amount has previously been included in gross income in a return under this act.....	.....

[illegible]

Addition 1921	199,572.42	213,806.19
.....
.....
.....
.....
Deferred Assets:		
.....		
.....		
.....		
.....		
.....		
Total assets	\$.....	\$.....
Liabilities.		
Notes payable		
Accounts payable—Receiver's Certificates		
Accrued items	\$8,500.00	\$9,000.00
Other liabilities—Bonded Debt .....	.....	10,000.00
Reserve for bad accounts	97,500.00	97,500.00
Reserve for depreciation .....	.....	.....
.....	35,672.62	37,014.48
Other Reserves:		
Capital stock—Common		
Preferred		
Surplus	65,400.00	65,400.00
Undivided profits .....	.....	.....
.....
Total liabilities	\$.....	\$.....

Affidavit of J. B. Duke.

Filed June 20, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.DISTRICT OF COLUMBIA,
City of Washington:

Personally appeared before me, a Notary Public, in and for the District of Columbia and City of Washington, J. B. Duke, a resident of the City of Washington, District of Columbia, who, upon being duly sworn, deposes, and says:

That he has been connected with the Accounting Department of the Southern Railway Company since March 1900, and is at this time the General Auditor of the Company, in charge of its books and accounts, which are under his immediate supervision and jurisdiction.

Affiant says that for the year 1921 the Southern Railway Company paid:

Item I. C. C.

Classification.

538.—Rent for passenger train cars.....	\$491,206.10
---	--------------

Southern Ry. received:

505.—Rent from passenger train cars.....	332,038.58
--	------------

In other words, the Southern paid out for rent of passenger train cars in 1921.....	159,167.72
---	------------

more than it received, of which amount 17½% or \$27,854.35 should be charged against its income in North Carolina.

Affiant further says that the Classification of Accounts of the Interstate Commerce Commission has as item 536 "hire of freight cars" which is commonly known as car hire, and that the Interstate Commerce Commission Classification has as item 538 "rent for pas-

senger Train cars" which is separate from and not that account which is commonly known as car hire.

Affiant further says that under item 541 of the Interstate Commerce Commission Classification known as "joint facility rents" there is a debit against the Southern Railway Company applicable to North Carolina of \$213,767.07, the principal items of which debit are the cost of trackage right Selma, N. C., to Pinners Point, Va., and the cost for the use of terminals at Durham, Goldsboro and Raleigh, N. C.

J. B. DUKE,

Subscribed and sworn to before me, this 8th day of June, 1922.

[Notarial Seal.]

J. C. NAUGHTEN,
Notary Public.

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Affidavit of M. S. Hawkins.

Filed June 20, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS et al.

M. S. Hawkins, being first duly sworn, deposes and says that he is Secretary of Norfolk Southern Railroad Company, having occupied that position since the Company's organization in 1910.

If it is intended by the affidavit of A. J. Maxwell filed in this cause to suggest that the capital stock of this Company was issued as a bonus or gift, such statement is incorrect and untrue.

Norfolk & Southern Railway Company, predecessor in title of complainant, in many of its properties, issued and sold mortgage bonds to the amount of fourteen million dollars and also certain capital stock, as appears from the records of that company.

Norfolk & Southern Railway Company, being unable to meet its obligations as they matured, the Mortgage securing the bonds was foreclosed and the property was sold and bought by a committee of bondholders who issued the capital stock of the present Norfolk Southern Railroad Company to the bondholders of the Old Norfolk & Southern Railway Company in lieu of the said bonds and stocks.

Under no system of accounting that affiant has ever seen or heard of, can interest paid by an operating corporation be properly charged as a capital expense. Capital expenses are supposed under all proper systems of accounting to represent expenditures made to increase the

- assets of the Company, while interest is a liability incurred
 75 for the use of money borrowed and chargeable to income, and constitutes a liability and not an asset.

A system of accounting which provided for entering interest paid by an operating corporation as a capital expenditure would be incorrect, misleading and calculated to lead to gross errors, if nothing more.

One of the chief differences between interest and dividend is that interest is a direct obligation of the borrower to pay the lender for the use of money, whether a profit is made or not, while dividends are not a direct obligation to pay at all hazards, as is interest, but dividends can properly be payable only out of net earnings of the business after all expenses, (including interest) and losses, are paid, adjusted, liquidated or taken care of, leaving the capital intact.

Under the Income Tax Laws of North Carolina, as affiant understands them, as to individuals and all corporations other than those required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, the payee, or recipient of the interest, (lender of the borrowed money on which interest accrues) is required to include interest received (except that on certain governmental obligations) in his or its gross income for the purpose of ascertaining the net income subject to tax, and the payer of such interest (borrower of the money) deducts the interest thus paid from his or its gross income, while in the case of dividends the payee, or recipient of the dividends, excludes or omits the dividends from his or its gross income, and the payer of such dividends includes the amount paid as a part of his or its taxable income (provided that the payer pays an income tax to the State) thus the amount so paid as either interest or dividends is only taxed as income one time.

In case of corporations required to keep records according to the standard classification of accounting of the Interstate Commerce Commission (if the statute is held constitutional) both
 76 the payee of the interest (that is the lender of the money) and the payer of the interest (the borrower of the money) will be compelled to include the interest received and paid in their gross income, for taxation without allowing any deduction to either, thus making double taxation.

So with rent paid for use of property by individuals and corporations, other than those required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, the payee or lessor of certain property includes rent received in his or its gross income, and the payer of the rent, or lessee of the property, deducts the amount of rent paid from his or its gross income, and the money representing such rent is taxed once only for income purposes, while under the statute, (if constitutional) corporations keeping their records according to the standard classification of accounting of the Interstate Commerce Commission, renting property for use in the business, the payee or lessor of the property, must include the rent received for the use of such property in his or its gross income for the purpose of income taxation, and the

payer of such rent, or lessee, it not permitted to deduct such rent from its gross income in order to arrive at the net income taxable, and, therefore, subjecting the rent to double taxation, thus creating a direct discrimination or double taxation on those corporations which are required to keep their records according to the standard classification of accounting of the Interstate Commerce Commission.

Affiant is advised that only those corporations engaged in operating steam or electric railroads in transportation of passengers and property in Interstate Commerce, and pipe lines carrying certain commodities, and of intelligence, are required to keep records in accordance with the standard classification of accounting of the Interstate Commerce Commission, and therefore, as affiant is advised, informed, and believes, corporations that are engaged in Interstate Commerce in the manner above indicated are penalized for transacting
77 and carrying on interstate commerce.

Affiant is informed, believes and alleges that it is not the general rule that corporations operating railroads engaged in transporting freight and passengers in interstate commerce are financed almost entirely by bond issues.

Norfolk Southern Railroad Company is not financed in that way. As of December 31, 1921 the Company has outstanding capital stock of the par value of sixteen million dollars, and its funded debt was \$19,608,600.

Affiant avers that Moody's publication of the financial condition of industrial corporations is a standard authority for the financial condition of such corporations.

An examination of that publication issued for the year 1922 discloses that as to the corporations hereinafter named, which affiant is informed, believes and alleges were during the income tax year 1921, and are now, engaged in operating and doing business in the State of North Carolina, as to their relative capital stock issue and funded debt, and bills and accounts payable, as follows, to-wit:

Liggett & Myers Tobacco Co., capital stock \$55,188,300, funded debt \$29,320,600.

Royster Guano Company, capital stock \$2,473,800, and stock of subsidiaries \$331,800, funded debt \$2,500,000, bills and accounts payable \$4,252,175.00.

Virginia Carolina Chemical Company, capital stock \$18,652,972.00 bonds \$26,267,000, bills payable \$27,421,708, total of bonds and bills payable \$53,689,403.00.

Armour & Company, capital stock \$150,000,000.00 bonds \$115,560,900, bills payable \$129,198,913.00.

Consolidated Textile Corporation, capital stock \$26,452,195 with a foot note stating "representing capital, surplus and 801,039 shares of no par value." Bonded debt of \$12,500,000, bills and accounts payable \$14,706,360.00.

78 Affiant has not had access to Moody's publication as to public utilities for the year 1922, but such publication for the year 1921, as to public utility corporations, disclosed that as appears therein, the relative capital stock issue and bonded indebted-

ness of some of the public utility corporations, which as affiant is informed, believes and alleges, are not required to keep records in accordance with the standard classification of accounting if the Interstate Commerce Commission, were as follows:

Southern Power Company, capital stock ten million dollars, bonded debt seven million dollars.

Asheville Power & Light Company, of Asheville, N. C., capital stock \$1,639,700 bonded debt \$1,220,000.

Southern Public Utilities Company, capital stock six million dollars, underlying bonds \$1,773,500.00, 5% gold bonds \$4,487,700.

Affiant avers that the real and true difference in financing corporations operating railroads engaged in transporting passengers and property in interstate commerce on the one side and industrial corporations and public utility corporations on the other side, and the reason therefor, arose out of the legal restrictions which have from time to time been placed on and around such railroad corporations and from which industrial corporation- are free, i. e. such railroad corporations are not allowed to issue any bonds, stocks or securities except a limited amount of short term notes, until and only to the extent that the duly authorized governmental body shall after investigation find and certify that the issuance of such securities is for some lawful object within its corporate purposes and is compatible with the public interest and is necessary or appropriate and consistent with the proper performance of service to the public and will not impair the ability of such corporation to perform that service and is reasonably necessary for that purpose and after full and complete showing as to the terms upon which the securities are to be sold and the rate of interest they are to bear, while ordinary industrial corporations and many public utility corporations are allowed to issue and

sell their securities upon such terms and for such purposes as

79 to them may seem proper; that such railroad corporations are by law prevented from accumulating out of earnings funds with which to discharge (except to a very limited extent) money borrowed to supply the necessary public service, unless such money can be borrowed at a much lower rate than has obtained in the money markets of the world in the last several years, and at a lower rate than the law allows such railroad corporations to earn upon the value of their property devoted to public use, to-wit: 5½ per cent, or unless such railroad corporations deprive the holders of their stock of the returns for the use of money invested in such capital, and devote the same, if earned, to the discharge of the principal of bonds or securities issued for the benefit of the public while ordinary industrial corporations are allowed to earn any rate of return which they can, so far as any inhibition of the law provides; that the corporations operating railroads transporting passengers and freight in interstate commerce may be compelled, under heavy penalties, to provide funds with which to furnish services to the public, or quit entirely, which they are not permitted to do, unless and until they have obtained authority so to do from governmental bodies, which authority may be issued only and to the extent that after such investigation the gov-

ernmental body finds that the public will not be unduly inconvenienced while industrail corporations are allowed to issue securities whenever they desire, or desist from issuing them, and if they so desire shut down and quit without leave of license from any person or governmental authority whatsoever.

That all the advantages of financing and paying off and discharging loans is with industrial corporations and the limitation of the law against corporations operating railroads transporting freight and passengers in Interstate commerce compel and require them to resort, as far as possible, to the borrowing of money upon long terms, and thus creating obligations which they would not have if the laws were so designed and enacted as to anable such corporations to sell their capital stock.

M. S. HAWKINS.

Sworn and subscribed to before me this 9th day of June 1922.

[Notarial Seal.]

J. R. PRITCHARD,

Notary Public.

My commission expires Jan. 10, 1925.

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Affidavit of E. H. Kemper Without Exhibits.

Filed June 20, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.

Affidavit of E. H. Kemper.

DISTRICT OF COLUMBIA,
City of Washington:

Personally appeared before me, a Notary Public, in and for the District of Columbia and City of Washington, E. H. Kemper, a resident of the City of Alexandria, State of Virginia, who, upon being duly sworn, deposes and says:

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1. He is Comptroller of the Southern Railway Company and has occupied that position since June 7, 1918. Prior to that time, he had been General Bookkeeper, Assistant Auditor, Auditor and Assistant Comptroller of said Company since its organization in 1894; that he is thoroughly familiar with accounting.

2. He has read the Bill of Complaint and the Answer filed in this cause and the sections of the Income Tax Law of 1921 of North Carolina in reference thereto.

3. Affiant attaches hereto the Classification of Income Profit and Loss and General Balance Sheet accounts for Steam Railroads prescribed by the Interstate Commerce Commission, in accordance with Section 20 of the Act of Congress to Regulate Commerce, effective on July 1, 1914, and which is now and has been in effect since July 1, 1914, which said Classification is marked Exhibit "1."

4. Affiant also attaches hereto Classification of Operating Revenues and Operating Expenses of Steam Railroads prescribed by the Interstate Commerce Commission in accordance with Section 20 of an Act to Regulate Commerce effective July 1, 1914, and which has been in effect since that date and is now in effect, which said Classification is marked Exhibit "2."

82 5. Affiant also attaches as Exhibit "3" Page 301, Schedule 300 1, "Income Account for the Year," taken from the printed form of Annual Report to the Interstate Commerce Commission for the year ended December 31, 1921, which form is similar to that in effect since July 1, 1914.

6. Affiant further says that he is thoroughly familiar with the Classification of Accounts of the Interstate Commerce Commission, and has made a close study of them, and there is no such designation in the Classification of Accounts of the Interstate Commerce Commission as "net operating income."

7. Affiant further says that if under Section 202 of the Income Tax Act of 1921 of North Carolina the term, "net operating income" shall be construed to be the same as "net railway operating income," as that term is defined in Section 15 (a) of the Interstate Commerce Act, then the basis of arriving at the amount on which the North Carolina Income Tax is to be paid by a railroad whose business is wholly within the State differs from the basis prescribed for the Southern Railway, which operates partly within and partly without the State of North Carolina, in this: "Net railway operating income," as defined in Section 15 (a), is ascertained after deducting from gross operating income the accounts designated by the Interstate Commerce Commission as follows:

Account No. 537—Rent for Locomotives.

" " 538—Rent for Passenger Train Cars

" " 539—Rent for Floating Equipment.

" " 540—Rent for Work Equipment.

" " 541—Joint Facility Rents.

83 The Southern Railway Company, which operates partly within and partly without the State, is not allowed the above set forth deductions under the North Carolina Income Tax Law and therefore, the amount upon which the tax is paid is excessive and

criminary to the extent that said above set forth deductions are not allowed, and the amount of such excess is included and set forth in Exhibit "B" to the Bill filed in this case.

8. Affiant further states that in order to arrive at Southern Railway Company's "net income" from its records kept in accordance with the requirements of the Interstate Commerce Commission, it is entitled to deduct rents paid for property used in its operations from which revenue is derived and included in and forming a part of "railway operating revenues," the principal items of which are designated by the Interstate Commerce Commission under the following primary accounts:

Account No. 542—Rent for Leased Roads.

Under which account, as is shown by Exhibit "B" Southern Railway Company paid in the State of North Carolina for the year ended December 31, 1921, \$591,491.75, i. e.:

To the North Carolina Railroad Company an annual rental of \$286,000.00

For lease to Southern Railway Company, under agreement dated August 16, 1895, that company's property, under which agreement all operating revenues accrue to Southern Railway Company and are included in its statement of Railway Operating Revenues and under which operating agreement Southern Railway Company must pay all operating costs:

Lessened in 1921, through credit as required under Classification of Interstate Commerce Commission by amount received as Southern Railway Company's equity in property sold 43,432.50

Leaving net charge as included in Account No. 542—Rent for Leased Roads—as included in Exhibit "B" \$242,567.50

To the Atlanta and Charlotte Air Line Railway an annual rental of \$1,128,000.00

For lease to Southern Railway Company, under agreement dated March 26, 1881, that company's property extending from Charlotte, N. C., to Armour, Ga., under which agreement all operating revenues accrue

to Southern Railway Company and are included in its statement of Railway Operating Revenues, and under which operating agreement Southern Railway Company must pay all operating costs, of which annual rental there is assigned on the basis of a mileage division to States other than North Carolina

942,782.40

Leaving for North Carolina

185,217.60

To the North Carolina Midland Railroad Company an annual rental of ..

75,780.00

For lease to Southern Railway Company under agreement dated February 5, 1916, that company's property, under which agreement all operating revenues accrue to Southern Railway Company and are included in its statement of railway operating revenues, and under which operating agreement Southern Railway Company must pay all operating costs:

To the Atlantic & Danville Railway Company an annual rental of

218,000.00

85 For lease to Southern Railway Company, under agreement dated August 31, 1899, that company's property, extending from Danville to Norfolk, and branches, under which agreement all operating revenues accrue to Southern Railway Company and are included in its statement of Railway Operating Revenues, and under which operating agreement Southern Railway Company must pay all operating costs; of which annual rental there is assigned on the basis of a mileage division to States other than North Carolina

200,625.40

Leaving for North Carolina

17,374.60

To Southern Railway—Carolina Division—an annual rental of

358,750.00

For lease to Southern Railway Company, under agreement dated June 30, 1902, that company's property extending from Kingville, S. C., to Marion, N. C., Charleston, S. C., to Savannah River near Augusta, Ga., Cayce, S. C., to Hardeeville, S. C.,

and branches, under which agreement all operating revenues accrue to Southern Railway Company and are included in its statement of Railway Operating Revenues, and under which operating agreement Southern Railway Company must pay all operating costs; of which annual rental there is assigned on the basis of a mileage division to States other than North Carolina

288,197.95

Leaving for North Carolina 70,552.05

The Southern Railway Company has not taken title, was not taking title, and has no equity in any of the above properties leased and which are all used in the conduct of its railroad business in North Carolina.

§ Account No. 543—Miscellaneous Rents.

Under which account affiant claims Southern Railway Company is entitled, as shown by Exhibit "B," in order to arrive at its "net income" in accordance with the Classification of Accounts of the Interstate Commerce Commission, to deduct for the year ended December 31, 1921, \$1,981.35, because it represents proportion of cost of miscellaneous property rented in North Carolina used in its operation.

9. Affiant further states that in order to arrive at Southern Railway Company's "net income" in accordance with its records kept under the requirements of the Interstate Commerce Commission, there should be added to its operating income the accounts designated by the Interstate Commerce Commission as:

- Account No. 504—Rent from Locomotives.
- " " 505—Rent from Passenger Train Cars.
- " " 506—Rent from Floating Equipment.
- " " 507—Rent from Work Equipment.
- " " 510—Miscellaneous Rent Income.
- " " 511—Miscellaneous Non-Operating Physical Property.
- " " 513—Dividend Income.
- " " 514—Income from Funded Securities.
- " " 515—Income from Unfunded Securities and Accounts.
- " " 519—Miscellaneous Income.

10. Affiant further states that after adding and deducting the foregoing items of revenues and expenses received and incurred in the

operation of Southern Railway Company, it has not, in accordance with the Standard Classification of Accounts of the Interstate Commerce Commission, under the provisions of the Interstate Commerce Act, reached its "net income" applicable to the State of North Carolina for the year ended December 31, 1921, until it has been allowed to deduct such items of expense incurred in the operation of Southern Railway Company in North Carolina as may be classified in its records under orders of the Interstate Commerce Commission as:

Account No. 545—Separately Operated Properties—Loss.

" " 546—Interest on Funded Debt.

" " 547—Interest on Unfunded Debt.

" " 548—Amortization of Discount on Funded Debt.

" " 549—Maintenance of Investment Organization.

" " 550—Income Transferred to Other Companies.

" " 551—Miscellaneous Income Charges.

Affiant says, when the above accounts are properly deducted, Southern Railway Company reaches its "net income" as designated under the Rules and Regulations and Classification of the Interstate Commerce Commission as is shown by page 301 taken from the annual report form of the Interstate Commerce Commission, attached hereto as Exhibit "3."

11. Affiant further says that Southern Railway Company is discriminated against in that under Section 306 of the Revenue Act of 1921, there is allowed to others as deductions before arriving at "net income" rentals, interest, and other deductions acknowledged to be incurred in connection with and as an offset to operating revenue or income, while no such deductions are allowed Southern Railway Company under Section 202, and Southern Railway Company has of such deductible items the amount shown on Exhibit "B;" and affiant further says that, under all rules of accounting, "net income" is as a fact that amount received by railroad corporations, after deducting from their gross income, all expenses of operating their properties, including rentals paid for the continued use or possession of their rented property in the business of transportation, together with interest paid on indebtedness, and such deductions are allowable in arriving at "net income" under the Federal Income Tax Act.

12. Affiant further says that under Section 303 of the North Carolina Revenue Act of 1921 there is allowed corporations other than railroads and public service corporations, deductions for debts ascertained to be worthless and charged off within the income year, and Southern Railway Company asserts that such debts written off during the year accrued in North Carolina amounted to \$26,196.97 as shown by Exhibit "C," and that Southern Railway Company should be allowed to deduct said item before arriving at the sum on which the tax is to be paid.

Affiant further says that, as will be seen from Exhibit "3" hereto, the Interstate Commerce Commission, in its classification of accounts, prescribes that there shall be deducted before arriving at net income Account No. 548—"amortization of discount on funded debt." The text of that account, as set forth by the Interstate Commerce Commission, is as follows:

"This account shall be charged during each fiscal period with the proportion of the discount and expense on funded debt obligations applicable to that period. This proportion shall be determined according to a rule the uniform application of which through the interval between the date of sale and the date of maturity will extinguish the discount and expense on funded debt. The charge to this account for any period must not be either greater or less than the proportion of the balance remaining unamortized applicable to that period so long as any portion of the discount and expense remains unextinguished. (See special instruction for balance sheet accounts, Section 3.)

"NOTE.—The accounting company may, at its option, charge to profit and loss account No. 617 'Debt discount extinguished through surplus,' all or any portion of the discount and expenses on funded debt remaining at any time unextinguished."

The Southern Railway Company has made no deduction under 548, but, as is allowed it under the note to account 548 above set forth, the Southern has an equivalent account known as No. 617, "Debt Discount Extinguished Through Surplus," the text of which is as set forth in the Interstate Commerce Commission Classification:

"This account shall include appropriations of surplus made, at the option of the accounting company, to reduce or extinguish the discount and expense on funded debt. See income account No. 548 'Amortization of discount on funded debt,' and balance sheet account No. 725 'Discount on funded debt.'"

Therefore, the Southern has deducted under the Interstate Commerce Commission's accounting rules the above referred to item 617, as shown in Exhibit "C" to the bill of complaint filed in this case. The amount thereof applicable to North Carolina is \$71,728.88, which it is extinguishing through surplus as provided for under the classification of the Interstate Commerce Commission before reaching its taxable net income.

Therefore, affiant asserts that the true "net income" of Southern Railway Company applicable to the State of North Carolina on which income tax should be paid is \$456,798.56, as shown by Exhibit "C."

13. Affiant further states that Southern Railway Company's "net income," in whole or that part applicable to the State of North Carolina, can only be reached on the basis of its records, and under the rules and regulations of the Interstate Commerce Commission, when there is taken into consideration those ac-

counts hereinbefore designated as additions to its revenues and deductions therefrom, as shown on Exhibit "3."

Affiant further states that the assessed value of Southern Railway Company's property in North Carolina certified to it by the Commissioner of Revenue of the State of North Carolina for the year 1921 was \$96,306,357.00; and the total ad valorem taxes which will have to be paid by Southern Railway Company to the tax subdivisions of the State of North Carolina, if said assessment remains, amounts to \$1,147,409.62.

In addition to the foregoing taxes, Southern Railway Company received from the Commissioner of Revenue an assessment of a franchise tax of one-tenth of one per cent on an assessed value of \$96,306,357.00, the amount demanded being \$96,306.35. If the income tax demanded is collected, Southern Railway Company will pay to the State of North Carolina and its subdivisions on its property and earnings for the year 1921 a total sum of \$1,315,238.03.

E. H. KEMPER.

Subscribed and sworn to before me, this 31st day of May, 1922.

[L. S.]

HARRY K. PIMPER,

Notary Public.

92

Affidavit of F. C. Harding.

Filed June 20, 1922.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue, et al.

F. C. Harding, being duly sworn, deposes and says, that he is the President of the Greenville and Shelberdine Railroad Company; that the same was chartered in 1920; that the road is 12 miles long, extending from Greenville to Shelberdine and is of narrow gauge. That W. L. Hall is the Secretary of said Railroad Company and that David Hoots is General Superintendent, Engineer and Conductor. That this road has no office, either in Greenville or at Shelberdine or along the route of its railroad. That this road makes, as a general thing, one trip a day.

During the movement of fertilizer in the spring, it often makes two trips a day. That it carries freight for hire, from Greenville to any point along the road to Shelberdine and from Shelberdine to any point along the road to Greenville. That it issues no bills of lading. That the freight it carries from Greenville to Shelberdine, or along the route, is removed from the Atlantic Coast Line Railroad Company cars and placed in this company's car and is delivered along

the route to its several patrons. That while people along the route use this road as a convenience to travel, this company has never charged any passenger rates. That this company has never made any report to the State Corporation Commission or to the Internal Revenue Commissioner and of course has never made any interstate report as it does not do any interstate business as all of its business is intrastate. That this road is not a lumber road. It was originally built for a lumber road but when the Beaufort County Lumber Co., removed from Pitt County, the road was purchased by the present owners who afterwards incorporated under the style above named.

93 Affiant further states that the Greenville and Shelberdine Railroad Company does not keep its accounts according to the standard classification of accounts promulgated by the Interstate Commerce Commission.

F. C. HARDING.

Subscribed and sworn to before me this 20th day of June 1922.

M. V. HARDING,
Notary Public.

My commission expires Nov. 3, 1922.

94 Affidavit of J. C. Nelms, Jr. (May 17, 1922).

Filed June 20, 1922.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue, et al.

J. C. Nelms, Jr., being first duly sworn, deposes and says: That he is General Auditor of Norfolk Southern Railroad Company that during the year 1921, Norfolk Southern Railroad Company operated a line of railroad owned by Carthage & Pinchurst Railroad Company, extending from Pinchurst to Carthage, North Carolina, under a lease which had expired, the reason for the continued operation thereof being that it had been prohibited by the laws of the United States to abandon said line of railroad unless permission was granted by the Interstate Commerce Commission;

That during the year 1921, it paid as rent for the use of said property in the business or trade of Norfolk Southern Railroad Company the rent stipulated to be paid in said lease.

That Norfolk Southern Railroad Company had not taken title to and was not taking title to said property, and had no equity therein.

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J. C. NELMS, JR.

Subscribed and sworn to before me this 17th day of May 1922.

GILBERT C. REVEILLE,
Notary Public.

[SEAL.]

My commission expires on the 31st day of August, 1924.

95 *Affidavit of J. C. Nelms, Jr. (May 18, 1922).*

Filed June 20, 1922.

In the District Court of the United States for the Eastern District of
North Carolina.

SOUTHERN RAILWAY COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.

Affidavit.

J. C. Nelms, Jr., being first duly sworn, deposes and says:

That he is a citizen and resident of the County of Norfolk, and State of Virginia; that he is General Auditor of Norfolk Southern Railroad Company and has occupied that position since April, 1913; that he is familiar with the rules of accounting for steam and electric railroads as prescribed by the Interstate Commerce Commission.

On the 19th of May, 1914, effective July 1, 1914, the Interstate Commerce Commission issued orders classifying the accounts of steam railroads, and dividing the accounts into two classes:

- (1) Operating Revenues and Operating Expenses; and,
- (2) Income, Profit and Loss, and General Balance Sheet Accounts.

These rules are still in force, subject to such modifications and explanations as have been made by the Commission since that date.

That the order prescribing the classification of Operating Revenues and Operating Expenses of Steam Roads, among other things provided:

"It is ordered, That, the Classification of Operating Revenues and Operating Expenses of Steam Roads and the text pertaining thereto embodied in printed form to be hereafter known as Issue of 1914, a copy of which is now before this Commission, be, and is hereby, approved; that a copy thereof duly authenticated by the Secretary of the Commission be filed in its archives, and a second copy thereof in like manner authenticated, in the office of the Division of Carriers' Accounts; and that each of said copies so authenticated and filed shall be deemed an original record thereof.

"It is further ordered, That the said Classification of Operating Revenues and Operating Expenses of Steam Roads, with the text pertaining thereto, be, and is hereby, prescribed for the use of carriers by rail (exclusive of electric railways) subject to the provisions of the Act to Regulate Commerce as amended, in the keeping and recording of their operating revenue and operating expense accounts; that each and every such carrier and each and every receiver or operating trustee of any such carrier be required to keep all operating revenue and operating expense accounts in conformity therewith; and that a copy of said issue be sent to each and every such carrier and to each and every receiver or operating trustee of any such carrier."

This affiant has a copy of the said order and the classification of accounts and instructions accompanying the same.

Accompanying said order, as sent to the carriers, was an introductory letter, which among other things stated that:

"Accounts are provided in this classification for the revenues and expenses of operations which heretofore have been classed as auxiliary or outside operations. The purpose in merging these accounts has been to secure a statement of revenues and expenses in connection with the operation of all physical property the cost of which is includible in the accounts for investment in road and equipment. The accounts for maintenance of physical property have been arranged to correspond with those for the investment in such property. Depreciation accounts have been provided for the current depreciation of fixed improvements, although until further directed the recognition in operation expenses of current depreciation of fixed improvements is optional with the carrier. It is provided that organization and general administration expenses directly assignable to investments in stocks, bonds, and other securities shall be excluded from the accounts of this classification and included in income account No. 549, "Maintenance of investment organization."

There also accompanied said order and classification certain general instructions, among which were the following:

"1. Operating Accounts.—The accounts of this classification are designed to show the revenues and expenses (including the maintenance of the facilities used) of the carrier's railway operations, including rail-line transportation, water-line transportation, if any, and services incident to transportation. Transportation includes the receipt, conveyance, and delivery of traffic."

"4. Miscellaneous Operations.—The revenue and expenses of miscellaneous operations involving the use of such facilities as hotels and restaurants, power plants, cold-storage plants, coal-storage plants, cotton compress plants, wood-preserving plants, ice-supply plants, etc., shall not be included in the accounts of this classification when the facilities used are distinct from those used by the carrier in the service of transportation or in the maintenance of facilities used in transportation service, and the operations are not

incident to such service. (See income accounts No. 502, "Revenue from miscellaneous operations," and No. 534, "Expenses of miscellaneous operations," and balance-sheet account No. 705, "Miscellaneous physical property.")"

There also accompanied said order certain special instructions, among which was:

"1. Accounts for Operating Revenues.—The accounts provided for operating revenues are designed to show amounts of money which a carrier becomes entitled to receive from transportation and from operations incident thereto."

The Operating Revenue accounts were by the said classification divided into general accounts and primary accounts. A statement of the general accounts and primary accounts for steam railroads, according to the said classification, showing the number of each account, as set out in said rule and order is hereto attached marked Exhibit A and prayed to be taken as a part of this affidavit.

The said order prescribed that account 142 "Rents of Buildings and other property," should include: "the revenue from the exclusive use of buildings and other property or portions thereof, such as depot and station grounds and buildings, general and other offices, wharves, ferry landings, elevators, stockyards, fuel yards, enginehouses, repair shops, and section and other houses, when the property is operated and maintained in connection with the property used in the carrier's transportation operations and the expenses of maintaining and operating the rented portion cannot be separated from the expenses of that portion used by the carrier."

As to the General Account No. IV, Joint Facility, being primary accounts Nos. 151 and 152, the said order provides that these accounts should include the carrier's proportion of revenue collected by others in connection with the operation of joint tracks, yards, terminals and other facilities, and also that proportion of revenue from the operation of joint tracks, yards terminals and other facilities, which is creditable to other companies.

The account did not include the rent paid for the use of the joint facilities, simply results of operations.

The operating expenses were by said order divided into eight general accounts, and into quite a number of primary accounts. A statement is hereto attached showing the general and primary accounts of steam railroads. Said statement is marked Exhibit B and is prayed to be taken as a part hereof.

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The special instructions accompanying said order, among other things, stated that: "The accounts prescribed for operating expenses are designed to show expenses of furnishing transportation service, including the expenses of maintaining the plant used in the service."

The accounts of Norfolk Southern Railroad Company are and have been kept in accordance with the rules and regulations prescribed by the Interstate Commerce Commission as set out in said orders, as

explained by the instructions and orders of the Commission, modifying or explaining the aforesaid order of May 19, 1914.

The said accounts and reports made to the Commission in accordance with said rules and regulations do not contain any such term as "Net Operating Income." The reports of Norfolk Southern Railroad Company made to the Interstate Commerce Commission show the total amount of its operating revenues and also shows the total amount of its operating expenses, and also the difference between these two amounts, which in said reports, and under the rules prescribed by the Interstate Commerce Commission, is denominated and known as "Net Revenue from Railway Operations." The Net Revenue from Railway Operations of Norfolk Southern Railroad Company and of corporations operating steam or electric railroads, keeping their accounts in accordance with the standard classification of accounting of the Interstate Commerce Commission, is the difference between the amount of money which Norfolk Southern Railroad Company or such other similar corporations, receives from transportation, as the term "Transportation" is defined in the said classification of accounts and in the Interstate Commerce Act, and the amount paid out for "all the ordinary and necessary expenses paid during the income year for conducting and carrying on transportation, as transportation is defined in the said classification of accounts and in the Interstate Commerce Act, including as a part of said expenses depreciation on its equipment, to-wit: steam locomotives, other locomotives, freight train cars, passenger train cars, motor equipment of cars, floating equipment, work equipment and miscellaneous equipment, if any."

Accounts of operating revenues and operating expenses of steam railroads, such as Norfolk Southern Railroad Company, and other similar corporations, kept in accordance with standard classification of accounting of the Interstate Commerce Commission do not include all gain derived from capital or labor or both combined, provided it is understood that the term "gain" includes profit gained through a sale or conversion of capital assets.

The said operating revenues and operating expenses of steam roads does not include the following items of gain or income which such corporations may receive during any period of time, but said items or sources of revenue or gain are in accordance with said classification carried under what is known as income accounts, to-wit: revenues from miscellaneous operations, hire of freight cars, credit balance, rents from locomotives, rents from passenger train cars, rents from floating equipment, rents from work equipment, joint facility rent income, income from lease of road, miscellaneous rent income, miscellaneous non-operating physical property, separately operated properties,—profit, dividend income, income from funded securities, income from unfunded securities and accounts, income from sinking and other reserve funds, release of premiums on funded debt, contributions from other companies, and miscellaneous income, all of which are gain from labor or capital or both combined, or from a sale or conversion of capital assets.

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The accounts of operating revenues and operating expenses of steam railroads, when such accounts are kept in accordance with the standard classification of accounting of Interstate Commerce Commission, do not include all of the expenses of conducting and carrying on the business of the corporation, and do not include many items of expenses which are necessary to be paid in order that the business may be carried on, to-wit: railway tax accruals; uncollectible railway revenues; expenses of miscellaneous operations; taxes on miscellaneous operating property; hire of freight cars—debit balance; rent for locomotives; rent for passenger-train cars; rent for floating equipment; rent for work equipment; joint facility rents; rent for leased roads; miscellaneous rents; miscellaneous tax accruals; separately operated properties—loss; interest on funded debt; interest on unfunded debt; amortization of discount on funded debt; maintenance of investment organization; income transferred to other companies; miscellaneous income charges; income applied to sinking and other reserve funds; dividend appropriations of income; income appropriated for investment in physical property; stock discount extinguished through income; and miscellaneous appropriations of income.

Under the aforesaid orders of the Interstate Commerce Commission dividing the accounts of corporations, operating steam railroads engaged in interstate commerce, into the two general classes as aforesaid, to-wit: Operating Revenues and Operating Expenses on the one part, and Income, Profit and Loss, and General Balance Sheet Accounts on the other, the Interstate Commerce Commission prescribed with great care and particularity the items of revenue which should go into each of the income accounts both credit and debit accounts.

A list of the primary accounts constituting the income accounts under said classification, both credit and debit is hereto attached, marked Exhibit C and prayed to be taken as a part hereof.

In addition, the said order of the Commission in prescribing rules of accounting for corporations operating steam railroads engaged in interstate commerce, prescribed a form of income statement. A copy of said form is hereto attached and made a part hereof, marked Exhibit D, and prayed to be taken as a part hereof.

100 The accounts of Norfolk Southern Railroad Company are kept in accordance with the aforesaid classification, its income statement is made to accord with the form of income statement prescribed in said rules of accounting and it reports to the Interstate Commerce Commission its operating revenues, operating expenses, other items of intake and outgo, all as prescribed by the Interstate Commerce Commission.

The term "Operation Ratio" does not appear in said rules of accounting. The term "operating ratio" is generally understood to mean and be that percent which the operating expenses as prescribed by the Interstate Commerce bears to the operating revenues as prescribed by the Interstate Commerce Commission.

The difference between the operating revenue and operating expenses of a corporation operating the steam railroads in keeping its accounts in accordance with the rules of the Interstate Commerce Commission does not show or purport to show the net income of such

corporations, but purports to show and shows the difference between the amount of revenue received from the business of conducting and carrying on its transportation and the operations incident thereto and the cost and expense of conducting such transportation and the incidents thereto.

In order to obtain the net income of such corporations it is necessary to consider and take into consideration the income accounts of said corporation as prescribed and shown in the rules of accounting of the Interstate Commerce Commission, and is set out in the form of income statement prescribed by the Commission, and which such railroad companies are required to make to the Commission.

Norfolk Southern Railroad Company owns and operates a line of electric railroad which runs from Norfolk to Virginia Beach and thence to Cape Henry, thence returning to Norfolk. In making reports to the Interstate Commerce Commission under the orders of the Commission the accounts of the electric division and the steam division are combined. Under permission granted by the Interstate Commerce Commission, Norfolk Southern Railroad Company keeps records showing the accounts of the electric division or electric railroad separate from the steam division or steam railroad. No part of the electric railroad is situated in North Carolina. The steam railroad extends and is situated both in North Carolina and Virginia. The ratio of operating expenses to operating revenue of the electric division was for the year 1921, 74.37% and for the steam division 84.51%, and for the entire system including both steam and electric divisions, 83.81%. That is to say that out of every dollar received by Norfolk Southern Railroad Company in payment for services rendered in the conduct of transportation on its electric division, as transportation is defined in classification of accounts of the Interstate Commerce Commission, it paid out in operating expenses, as

such operating expenses are defined in said classification of accounts, 74.37 cents. That on its steam division, which is located partly in North Carolina and partly in Virginia, where the business is both local and through, in both states, out of every dollar taken in for services rendered in the conduct of transportation, both intra and interstate, it became necessary to pay, and the company did pay in operating expenses as operating expenses are defined in said classification, the sum of 84.51 cents. That considering its entire system, both electric and steam, out of every dollar taken in payment for services rendered in transportation, both interstate and intrastate, as transportation is defined in the standard classification of accounting of the Interstate Commerce Commission, it becomes necessary for Norfolk Southern Railroad Company to pay for operating expenses in conducting transportation, as transportation is defined in the classification of accounting of the Interstate Commerce Commission 83.81 cents.

That in addition to the operating expenses aforesaid it became necessary for Norfolk Southern Railroad Company, in order to conduct and carry on its business and especially its business on steam division, to pay sums and items as set out in section 23 of the bill of complaint filed in this case.

During the calendar year 1921, which was the income year 1921, Norfolk Southern Railroad Company paid expenses for conducting and carrying on its business which are not included under the head of operating expenses under the rules of accounting of the Interstate Commerce Commission, as follows, to-wit:

Joint Facility Rents, that is rents for tracks, yards, terminals and other facilities owned or controlled by other carriers, companies or individuals, and in the joint use of which Norfolk Southern Railroad Company participated, in the sum of \$37,366.96 of which \$34,009.76 was allocatable to that part of the road located in North Carolina.

For rent of roads, tracks or bridges, including equipment and other railway property covered by the contract of lease of other companies held under lease or other agreement, by the terms of which the exclusive use and control for operating purposes are secured, the sum of \$160,365.96, the entire amount of which was for properties located in North Carolina.

For the use of miscellaneous property, that is property which was not used in the operation of the railroad, but used in the conduct of its business and necessary so to be used, the sum of \$1,376.63 of which \$372.83 was allocatable to North Carolina.

For interest on its funded debt the sum of \$884,399.57 of which \$778,351.22 was and is allocatable to the State of North Carolina.

For interest on unfunded debt \$37,025.96, of which \$32,587.06 is allocatable to North Carolina.

102 For amortization of discount on funded debt, being a proportion of the discount and expense on funded debt of the company applicable to that period, in accordance with the standard rules of accounting of the Interstate Commerce Commission \$24,719.53 of which \$21,755.41 was and is allocatable to North Carolina.

Other expenses of conducting and carrying on its business which, in the standard classification of accounting of the Interstate Commerce Commission is designated as miscellaneous income charges, the sum of \$57,697.34, of which \$50,778.85 is allocatable to the State of North Carolina.

That Norfolk Southern Railroad Company had not taken title, was not taking title, and had no equity in any of the properties leased including the railroads or joint facilities, and which are referred to as having been secured for its use in the conduct of its business by payment of the rents aforesaid.

That under the orders of the Commission, the form of accounting prescribed for operating expenses carried accounts "for the current depreciation of fixed improvements." The said orders and instructions further provided that the recognition of and charging out in operating expenses current depreciation of fixed improvements is and was optional with the carrier. Norfolk Southern Railroad Company has never charged out in its operating expenses any current depreciation for fixed improvements.

(S)

J. C. NELMS, JR.

Sworn and subscribed to before me this 18 day of May, 1922.

(S)
[SEAL.]

GILBERT C. REVEILLE,
Notary Public.

My commission expires on the 31st day of August, 1924.

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EXHIBIT A.

Operating Revenue Accounts.

General Accounts.

- I. Transportation—Rail Line.
- II. Transportation—Water Line.
- III. Incidental.
- IV. Joint Facilities.

Primary Accounts.

I. Transportation—Rail line:

101. Freight.
102. Passenger.
103. Excess baggage.
104. Sleeping car.
105. Parlor and chair car.
106. Mail.
107. Express.
108. Other passenger-train.
109. Milk.
110. Switching.
111. Special service train.
112. Other freight-train.
113. Water transfers—Freight.
114. Water transfers—Passenger.
115. Water transfers—Vehicles and live stock.
116. Water transfers—Other.

II. Transportation—Water line—

121. Freight.
122. Passenger.
123. Excess baggage.
124. Other passenger service.
125. Mail.
126. Express.
127. Special service.
128. Other.

III. Incidental—

- 131. Dining and buffet.
- 132. Hotel and restaurant.
- 133. Station, train, and boat privileges.
- 134. Parcel room.
- 135. Storage—Freight.
- 136. Storage—Baggage.
- 137. Demurrage.
- 138. Telegraph and telephone.
- 139. Grain elevator.
- 140. Stockyard.
- 141. Power.
- 142. Rents of buildings and other property.
- 143. Miscellaneous.

IV. Joint Facility—

- 151. Joint Facility—Cr.
- 152. Joint Facility—Dr.

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EXHIBIT B.

Operating Expense Accounts.

General Accounts.

- I. Maintenance of Way and Structures.
- II. Maintenance of Equipment.
- III. Traffic.
- IV. Transportation—Rail line.
- V. Transportation—Water line.
- VI. Miscellaneous operations.
- VII. General.
- VIII. Transportation for investment—Cr.

Primary Accounts.

I. Maintenance of Way and Structures—

- 201. Superintendence.
- 202. Roadway maintenance.
- 203. Roadway—Depreciation.
- 204. Underground power tubes.
- 205. Underground power tubes—Depreciation.
- 206. Tunnels and subways.
- 207. Tunnels and subways—Depreciation.
- 208. Bridges, trestles, and culverts.
- 209. Bridges, trestles, and culverts—Depreciation.
- 210. Elevated structures.
- 211. Elevated structures—Depreciation.
- 212. Ties.

213. Ties—Depreciation.
214. Rails.
215. Rails—Depreciation.
216. Other track material.
217. Other track material—Depreciation.
218. Ballast.
219. Ballast—Depreciation.
220. Track laying and surfacing.
221. Right-of-way fences.
222. Right-of-way fences—Depreciation.
223. Snow and sand fences and snowsheds.
224. Snow and sand fences and snowsheds—Depreciation.
225. Crossings and signs.
226. Crossings and signs—Depreciation.
227. Stations and office buildings.
228. Stations and office buildings—Depreciation.
229. Roadway buildings.
230. Roadway buildings—Depreciation.
231. Water stations.
232. Water stations—Depreciation.
233. Fuel stations.
234. Fuel stations—Depreciation.
235. Shops and enginehouses.
236. Shops and enginehouses—Depreciation.
237. Grain elevators.
238. Grain elevators—Depreciation.
239. Storage warehouses.
240. Storage warehouses—Depreciation.
241. Wharves and docks.
242. Wharves and docks—Depreciation.
243. Coal and ore wharves.
244. Coal and ore wharves—Depreciation.
245. Gas producing plants.
246. Gas producing plants—Depreciation.
247. Telegraph and telephone lines.
248. Telegraph and telephone lines—Depreciation.
249. Signals and interlockers.
250. Signals and interlockers—Depreciation.
251. Power plant dams, canals, and pipe lines.
252. Power plant dams, canals, and pipe lines—Depreciation.
253. Power plant buildings.
254. Power plant buildings—Depreciation.
255. Power substation buildings.
256. Power substation buildings—Depreciation.
257. Power transmission systems.
258. Power transmission systems—Depreciation.
259. Power distribution systems.
260. Power distribution systems—Depreciation.
261. Power line poles and fixtures.
262. Power line poles and fixtures—Depreciation.

- 263. Underground conduits.
- 264. Underground conduits—Depreciation.
- 265. Miscellaneous structures.
- 266. Miscellaneous structures—Depreciation.
- 267. Paving.
- 268. Paving—Depreciation.
- 269. Roadway machines.
- 270. Roadway machines—Depreciation.
- 271. Small tools and supplies.
- 272. Removing snow, ice and sand.
- 273. Assessments for public improvements.
- 274. Injuries to persons.
- 275. Insurance.
- 276. Stationery and printing.
- 277. Other expenses.
- 278. Maintaining joint tracks, yards, and other facilities—
Dr.
- 279. Maintaining joint tracks, yards, and other facilities—
Cr.

II. Maintenance of Equipment—

- 301. Superintendence.
- 302. Shop machinery.
- 303. Shop machinery—Depreciation.
- 304. Power plant machinery.
- 305. Power plant machinery—Depreciation.
- 306. Power substation apparatus.
- 307. Power substation apparatus—Depreciation.
- 308. Steam locomotives—Repairs.
- 309. Steam locomotives—Depreciation.
- 310. Steam locomotives—Retirements.
- 106 311. Other locomotives—Repairs.
- 312. Other locomotives—Depreciation.
- 313. Other locomotives—Retirements.
- 314. Freight-train cars—Repairs.
- 315. Freight-train cars—Depreciation.
- 316. Freight-train cars—Retirements.
- 317. Passenger-train cars—Repairs.
- 318. Passenger-train cars—Depreciation.
- 319. Passenger-train cars—Retirements.
- 320. Motor equipment of cars—Repairs.
- 321. Motor equipment of cars—Depreciation.
- 322. Motor equipment of cars—Retirements.
- 323. Floating equipment—Repairs.
- 324. Floating equipment—Depreciation.
- 325. Floating equipment—Retirements.
- 326. Work equipment—Repairs.
- 327. Work equipment—Depreciation.
- 328. Work equipment—Retirements.
- 329. Miscellaneous equipment—Repairs.

- 330. Miscellaneous equipment—Depreciation.
- 331. Miscellaneous equipment—Retirements.
- 332. Injuries to persons.
- 333. Insurance.
- 334. Stationery and printing.
- 335. Other expenses.
- 336. Maintaining joint equipment at terminals—Dr.
- 337. Maintaining joint equipment at terminals—Cr.

III. Traffic—

- 351. Superintendence.
- 352. Outside agencies.
- 353. Advertising.
- 354. Traffic associations.
- 355. Fast freight lines.
- 356. Industrial and immigration bureaus.
- 357. Insurance.
- 358. Stationery and printing.
- 359. Other expenses.

IV. Transportation—Rail line—

- 371. Superintendence.
- 372. Dispatching trains.
- 373. Station employees.
- 374. Weighing, inspection, and demurrage bureaus.
- 375. Coal and ore wharves.
- 376. Station supplies and expenses.
- 377. Yardmasters and yard clerks.
- 378. Yard conductors and brakemen.
- 379. Yard switch and signal tenders.
- 380. Yard enginemen.
- 381. Yard motormen.
- 382. Fuel and yard locomotives.
- 383. Yard switching power produced.
- 384. Yard switching power purchased.
- 385. Water for yard locomotives.
- 386. Lubricants for yard locomotives.
- 387. Other supplies for yard locomotives.
- 388. Enginehouse expenses—Yard.
- 389. Yard supplies and expenses.
- 390. Operating joint yards and terminals—Dr.
- 391. Operating joint yards and terminals—Cr.
- 392. Train enginemen.
- 393. Train motormen.
- 394. Fuel for train locomotives.
- 395. Train power produced.
- 396. Train power produced purchased.
- 397. Water for train locomotives.
- 398. Lubricants for train locomotives.
- 399. Other supplies for train locomotives.

- 400. Enginehouse expenses—Train.
- 401. Trainmen.
- 402. Train supplies and expenses.
- 403. Operating sleeping cars.
- 404. Signal and interlocker operation.
- 405. Crossing protection.
- 406. Drawbridge operation.
- 407. Telegraph and telephone operation.
- 408. Operating floating equipment.
- 409. Express service.
- 410. Stationery and printing.
- 411. Other expenses.
- 412. Operating joint tracks and facilities—Dr.
- 413. Operating joint tracks and facilities—Cr.
- 414. Insurance.
- 415. Clearing wrecks.
- 416. Damage to property.
- 417. Damage to live stock on right of way.
- 418. Loss and damage—Freight.
- 419. Loss and damage—Baggage.
- 420. Injuries to persons.

V. Transportation—Water line—

- 431. Operation of vessels.
- 432. Operation of terminals.
- 433. Incidental.

VI. Miscellaneous operations—

- 441. Dining and buffet service.
- 442. Hotels and restaurants.
- 443. Grain elevators.
- 444. Stockyards.
- 445. Producing power sold.
- 446. Other miscellaneous operations.

VII. General—

- 451. Salaries and expenses of general officers.
- 452. Salaries and expenses of clerks and attendants.
- 453. General office supplies and expenses.
- 108 454. Law expenses.
- 455. Insurance.
- 456. Relief department expenses.
- 457. Pensions.
- 458. Stationery and printing.
- 459. Valuation expenses.
- 460. Other expenses.
- 461. General joint facilities—Dr.
- 462. General joint facilities—Cr.

VIII. Transportation for investment—Cr.

EXHIBIT C.

Income Accounts.

Primary Accounts.

I. Credits:

501. Railway operating revenues.
502. Revenues from miscellaneous operations.
503. Hire of freight cars—Credit balance.
504. Rent from locomotives.
505. Rent from passenger-train cars.
506. Rent from floating equipment.
507. Rent from work equipment.
508. Joint facility rent income.
509. Income from lease of road.
510. Miscellaneous rent income.
511. Miscellaneous non-operating physical property.
512. Separately operated properties—Profit.
513. Dividend income.
514. Income from funded securities.
515. Income from unfunded securities and accounts.
516. Income from sinking and other reserve funds.
517. Release of premiums on funded debt.
518. Contributions from other companies.
519. Miscellaneous income.

II. Debits:

531. Railway operating expenses.
532. Railway tax accruals.
533. Uncollectible railway revenues.
534. Expenses of miscellaneous operations.
535. Taxes on miscellaneous operating property.
536. Hire of freight cars—Debit balance.
537. Rent for locomotives.
538. Rent for passenger-train cars.
539. Rent for floating equipment.
540. Rent for work equipment.
541. Joint facility rents.
542. Rent for leased roads.
543. Miscellaneous rents.
544. Miscellaneous tax accruals.
545. Separately operated properties—Loss.
546. Interest on funded debt.
547. Interest on unfunded debt.
548. Amortization of discount on funded debt.
549. Maintenance of investment organization.
550. Income transferred to other companies.
551. Miscellaneous income charges.
552. Income applied to sinking and other reserve funds.

- 553. Dividend appropriations of income.
- 554. Income appropriated for investment in physical property.
- 555. Stock discount extinguished through income.
- 556. Miscellaneous appropriations of income.

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EXHIBIT D.

Form of Income Statement.

I. Operating income—

- 501. *Railway operating revenues.
- 531. *Railway operating expenses.
- *Net revenue from railway operations.
- 532. *Railway tax accruals.
- 533. *Uncollectible railway revenues.
- *Railway operating income.
- 502. Revenues from miscellaneous operations.
- 534. Expenses of miscellaneous operations.
- Net revenue from miscellaneous operations.
- 535. Taxes on miscellaneous operating property.
- Miscellaneous operating income.
- Total operating income.

II. Non-operating Income—

- 503. Hire of freight cars—Credit balance.
- 504. Rent from locomotives.
- 505. Rent from passenger-train cars.
- 506. Rent from floating equipment.
- 507. Rent from work equipment.
- 508. Joint facility rent income.
- 509. Income from lease of road.
- 510. Miscellaneous rent income.
- 511. Miscellaneous non-operating physical property.
- 512. Separately operated properties—Profit.
- 513. Dividend income.
- 514. Income from funded securities.
- 515. Income from unfunded securities and accounts
- 516. Income from sinking and other reserve funds.
- 517. Release of premiums on funded debt.
- 518. Contributions from other companies.
- 519. Miscellaneous income.
- Total non-operating income.
- Gross income (or loss).

III. Deductions from gross income:

- 536. Hire of freight cars—Debit balance.
- 537. Rent for locomotives.

*Includes operations of water lines, if any.

- 538. Rent for passenger-train cars.
- 539. Rent for floating equipment.
- 540. Rent for work equipment.
- 541. Joint facility rents.
- 542. Rent for leased roads.
- 543. Miscellaneous rents.
- 544. Miscellaneous tax accruals.
- 545. Separately operated properties—Loss.
- 546. Interest on funded debt.
- 111 547. Interest on unfunded debt.
- 548. Amortization of discount on funded debt.
- 549. Maintenance of investment organization.
- 550. Income transferred to other companies.
- 551. Miscellaneous income charges.
- Total deductions from gross income.
- Net income (or loss).

IV. Disposition of Net Income:

- 552. Income applied to sinking and other reserve funds.
- 553. Dividend appropriations of income.
- 554. Income appropriated for investment in physical property.
- 555. Stock discount extinguished through income.
- 556. Miscellaneous appropriations of income.
- Total appropriations.
- Income balance transferred to credit (or debit) of Profit and Loss.

112 *Affidavit of J. C. Nelms, Jr. (June 12, 1922).*

Filed June 20, 1922.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS et al.

J. C. Nelms, Jr., being first duly sworn, deposes and says: that: Accompanying and constituting a part of the order of the Interstate Commerce Commission, made the 19th day of May, 1914, effective July 1st, 1914, and still in force, with such modifications and amendments as may have been made thereto, were certain special instructions of which No. 1 reads as follows:

"Income accounts are those designed to show, as nearly as practicable, for each fiscal period, the total amount of money that a carrier

becomes entitled to receive for services rendered, the returns accrued upon investments, the accrued costs paid or payable for the services rendered by it, the losses sustained by it, the amounts accrued for taxes, for use of moneys and for use of properties of others, and the appropriations made from income during the period. The net balance of income (or loss) shall be carried to Profit and Loss."

The order above referred to is the order of the Commission regulating the keeping of records by Interstate Carriers by Railroad, known as "Classification of Income, Profit and Loss, and General Balance Sheet Accounts for Steam Roads."

J. C. NELMS, JR.

Sworn and subscribed to before me this 12th day of June, 1922.

[SEAL.]

GILBERT C. REVEILLE,
Notary Public.

My commission expires the 31st day of August, 1924.

113 *Tender of Amount Admitted to be Due.*

Filed June 20, 1922.

June 3, 1922.

Hon. A. D. Watts,
Commissioner of Revenue of North Carolina,
Raleigh, North Carolina.

DEAR SIR:

I respectfully herewith make a return of the Southern Railway Company's net income for the calendar year 1921. You will note that this return is not made in accordance with the form prescribed by the State Department of Revenue. It shows, we respectfully submit, the true net income for the year 1921, and is made up in accordance with the Interstate Commerce Commission's Classification of Accounts.

I herewith tender check for the amount of the income tax based on said return, namely, three per cent on \$456,798.56, amounting to \$13,703.95. If you decline to accept this because of the tender of the check not being legal tender, I advise that I will procure you United States Government funds should you so desire.

I further respectfully offer to pay, when advised by you of the amount thereof, any interest or penalties that may be due on account of non-payment of said income tax prior to this date.

Yours very truly,

S. R. PRINCE,
General Solicitor.

114 *Declination of the Commissioner of Revenue to Receive Tender.*

Filed June 20, 1922.

State of North Carolina.

Department of Revenue.

A. D. Watts, Com.,

Raleigh, N. C.

Mr. S. R. Prince, General Solicitor,
Southern Railway System,
1300 Pennsylvania Ave.,
Washington, D. C.

June 5th, 1922.

DEAR SIR:

I acknowledge receipt of your letter of the 3rd enclosing return of the Southern Railway Company's net income for the calendar year 1921, which return is not made in accordance with form prescribed by this Department, together with tender of check of \$13,703.95, covering income tax in full less any interest or penalties which may have accrued, based on such return.

I am returning you this return and check, as the net income of the Southern Railway Company for the calendar year 1921 is not determined in accordance with the provisions of Section 202 of the income tax act, prescribing the method of determining net income for railroad companies.

Yours very truly,
(Signed)

A. D. WATTS,
Commissioner.

O. S. T.: M. B.

115 *Testimony of R. O. Self at Hearing Before Judge Connor.*

It is agreed that all affidavits filed in the cause by either of the plaintiffs or by the defendants will be treated as in evidence in all cases.

Mr. R. O. Self, Clerk of the North Carolina Corporation Commission produced a list of the corporations operating as limited common carriers in North Carolina under authority granted by the State Corporation Commission under section 3413 of the Consolidated Statutes of North Carolina. Also a memorandum adding two other roads was attached, all filed as Exhibit A.

R. O. SELF, witness for the defendant, examined by Judge Manning, testifies as follows:

"That the several roads mentioned in Exhibit A were lumber roads, for logging purposes, operating under Section 3413 of the Consolidated Statutes as a limited carrier, with the right to stop at any-time."

116 EXHIBIT "A" TO TESTIMONY OF R. O. SELF.

Office of the Corporation Commission.

STATE OF NORTH CAROLINA:

This is to certify, that the Corporation Commission of North Carolina, acting under power vested in it by Sec. 3413 of the Consolidated Statutes of North Carolina, has granted authority to the corporations named below to conduct and carry on the business of limited common carriers between the points designated as to each of the corporations named, and that said corporations have filed with the Corporation Commission of North Carolina tariffs establishing the rate of charges which they are authorized to make for the transportation of commodities between the points named.

The corporations named and the points between which they are authorized to act as limited common carriers, engaged in Intra-state Commerce in North Carolina over a line of steam railroad, are as follows:

Andrews Manufacturing Company, Between Andrews and Old Road Gap, a distance of 8 miles, of thereabouts.

Carr Lumber Company, Between Pisgah Forest and Vanderbilt Boundary, a distance of about 20 miles.

Empire Manufacturing Company, Between Oliver Station to within three miles of Bentonville, about 13 miles.

Enterprise Lumber Company, Between Mount Olive and New Camp, a distance of 18 miles, or thereabouts.

Fishing Creek Timber & Railroad Company, Between Stamper, N. C., and Coffield's Bridge, about 10 miles.

Carolina Southern Railroad, Between Hollister and Vaughan, a distance of 14½ miles, or thereabouts.

Montgomery Lumber Company, Between Spring Hope and Bunn, N. C., a distance of 10 miles or thereabouts.

Ocona Luffy Railroad Company, Between Ocona Luffy, N. C., and Smokemont, N. C., about 10 miles.

117 Rowland Lumber Company, Between Bowdens, N. C. and Warsaw, N. C., toward Newton Grove, a distance of about 20 miles.

Waccamew Lumber Company, Between Bolton and Makatoka, a distance of about 18 miles.

Weldon Lumber Company, Between Weldon, N. C., and a point near Ringwood, a distance of about 20 miles.

Whiteville Lumber Company, Between Whiteville, N. C., and Buttler, a distance of about 27 miles.

Mill Creek Valley Railroad Between — and — a distance of about — miles.

Suncrest Lumber Co., Sunburst to Canton.

Hilton Railroad & Lugging Co., Hilton Creek to Island Creek, 6 miles.

Done at the office of the Corporation Commission, at Raleigh, on this the — day of May 1922, by the Corporation Commission.

through W. T. Lee, its Chairman, and under the seal of the said Commission.

118 *Testimony of C. J. Joseph at Hearing Before Judge Connor.*

C. J. Joseph, Tax Agent of the A. C. L. Railroad, witness for the plaintiff, examined by Mr. Thomas W. Davis, testifies as follows:

"That he had for a great many years been the tax agent of that road, with the duty of checking and looking after all the taxes of that Company and its affiliated lines in Virginia, North and South Carolina, Georgia, Florida and Alabama. That he was familiar with this litigation and with the Income Tax Laws of North Carolina: that he has to keep up with the stocks and bonds and statistics of the various roads mentioned; that he is familiar with the commercial and financial Chronicle, a financial trade paper, circulated throughout the United States, that collects roads and industrial corporations and their stocks and bonds. The issue of May 27, 1922, of that paper was offered in evidence, and Mr. Davis desired to read into the record the capital stock and bonds of certain industrial corporations reporting to the North Carolina Tax Commission, the Tax Commission showing the capital, but not the bonds issued by them.

119 EXHIBIT TO TESTIMONY OF C. J. JOSEPH.

Representative Partial List of Industrial Corporations Doing Business in North Carolina and Reporting to the North Carolina Corporation Commission and Commissioner of Revenue Financed by Bonds and Stocks.

American Agricultural Chemical Company:

Common stock	\$33,322,126
Preferred Stock	28,455,200
First Mortgage bonds	6,252,000
1st Ref. Mortgage s. f. gold bonds, Series "A" ..	30,000,000

American Sugar Refining Company:

Common Stock	45,000,000
Preferred Stock	45,000,000
15 Year Gold Bonds	30,000,000

American Tobacco Company:

Common Stock "A"	40,242,400
Common Stock "B"	49,344,200
Preferred Stock	52,699,700
Gold Bonds	371,950
Gold Bonds & Cons, Tobacco Collateral Trust	
Trust Mortgage Bonds	1,365,300
Series of Gold Notes	10,000,000
8% Dividend Certificates	8,058,834

Dupont, I. E., de Nemours & Company:

Common stock	63,378,300
Debenture Stock	71,243,250
10 Year Gold Bonds	35,000,000

Galena Signal Oil Company:

Common Stock	16,000,000
Preferred Stock	2,000,000
New Preferred Stock	4,000,000
Convertible Debenture	6,000,000
Entire Stock of Subsidiary Companies.....	2,800,000
Galena Signal Oil of Texas Bonds	2,800,000

General Electric Company:

Common Stock	176,329,100
Debenture for Sprague Stock	2,047,000
Debenture	15,136,500
Debenture Bonds	15,000,000

120 Kelly Springfield Tire Company:

Common Stock	\$9,096,000
Preferred Stock	3,137,100
Second Preferred	5,625,200
10 Year s. f. Gold Notes	10,000,000

Morris Company:

1st Mortgage	17,626,000
10 Year s. f. Gold Notes.....	15,000,000
Wm. F. Mosser Co. 10 yr. s. f. notes	3,000,000

Swift & Company:

Common Stock	150,000,000
1st Mortgage s. f. Gold Bonds	28,923,500
Gold Notes	65,000,000

Texas Company:

Stock	164,450,000
3 yr. S. F. Notes	22,772,000

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Final Decree.

Filed Nov. 13, 1922.

In the District Court of the United States for the Eastern District of
North Carolina, Raleigh Division.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, and
JAMES S. MANNING, Attorney General of North Carolina.

Decree.

This is a suit in equity, brought by plaintiff, Southern Railway Company, a corporation chartered and organized under the laws of the State of Virginia, operating a line of railway in and through the State of North Carolina and the Eastern District thereof, against defendant, A. D. Watts, individually, and as Commissioner of Revenue of North Carolina and James S. Manning, Attorney General of said State, seeking an injunction restraining and enjoining said defendants from taking or causing to be taken any action toward enforcing the filing of a return or the collection of a tax or any part thereof, imposed, or sought to be imposed, by the State of North Carolina upon the plaintiff, under or by virtue of the provisions of the Public Laws of North Carolina of 1921, Chapter 34, known as the Revenue Act or the Income Tax Act, as amended by the General Assembly of North Carolina at its Special Session of 1921.

122 Following the service of process on the defendants and filing answer to the bill, the cause was set down for hearing upon the bill, answer and evidence.

Plaintiff alleges that, by the provisions of Article 5, Section 3 of the Constitution of North Carolina, the General Assembly is authorized to pass laws.

"Taxing, by a uniform rule, all moneys, credits, investments in bonds, stocks, joint-stock Companies, or otherwise, and also real and personal property, according to its true value in money. * * * The General Assembly may also tax trades, professions and incomes. Provided the rate of tax on incomes shall not, in any case, exceed six per cent, and there shall be allowed the following exemptions, to be deducted from the amount of annual incomes to-wit: For a married man, with a wife living with him, or to a widow or widower having minor child or children, natural or adopted, not less than \$2,000.00; to all other persons not less than \$1,000.00; and there

may be allowed other deductions (not including living expenses), so that only net incomes are taxed."

Pursuant to the provisions of the foregoing Art. of the Constitution, the General Assembly, at its Session of 1921, enacted a Statute providing for levying, collecting and paying an income tax on individuals and corporations. Chap. 34 Public Laws of North Carolina and known as a part of the Revenue Act of 1921, so far as it relates to the Income Tax as the "Income Tax Act of 1921."

The sections of this Act pertinent to the questions presented for decision by the plaintiff's contention are:

Section 101. Purpose.—

123 "The general purpose of this Act is to impose a tax for use of the State Government, upon the net income for the calendar year 1921, in excess of exemptions herein set out, collectible in the year 1922 and annually thereafter:

(a) Of every citizen of the State.

(b) Of every domestic corporation.

(c) Of every foreign corporation and of every non resident individual having a business or agency in this State in proportion to the net income of such business or agency.

"Except as otherwise provided in this act, the purpose is to conform to the definitions of income in the revenue laws of the United States Government and regulations made under its authority in so far as they apply."

"The tax imposed upon the net income of corporations in this Schedule is in addition to the tax imposed under Schedule "C" of this Act."

Section 201. Corporations.—

Every corporation organized under the laws of this State shall pay annually an income tax equivalent to three percent of the entire net income of such corporation, as herein defined, received by such corporation during the income year; and every foreign corporation doing business in this State shall pay annually an income tax equivalent to three per cent of a proportion of its entire net income, to be determined according to the following rules.

In case of a company or companies mentioned in the next succeeding section, deriving profits principally from the ownership sale or rental of real estate or from the manufacture sale, or use of tangible personal property, such proportion of its entire net income as the fair cash value of its real estate and tangible personal property, in this State, on the date of the close of the fiscal year of such company in the income year is to be the fair cash value of its entire real estate and tangible personal property then owned by it, with no deduction on account of incumbrances thereon.

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In case of a corporation deriving profits principally from the holding or sale of intangible property such proportion as its gross receipts in this State for the year ended on the date of the close of its fiscal year next preceding is to its gross receipts for such year within and without the State.

"Section 202. Railroads and public service corporations.—

"The basis of ascertaining the net income of every corporation engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the Standard Classification of Accounting of the Interstate Commerce Commission, shall be the 'net operating income' of such corporations as shown by their records kept in accordance with that Standard Classification of Accounts, when their business is wholly within this State and when their business is in part within and in part without this State, including in their gross 'operating revenues' within this State the equal mileage proportion within this State of their interstate business and deducting from their gross 'operating revenues' the proportionate average of operating expenses' or 'operating ratio', for their whole business, as shown by the Interstate Commerce Commission Standard Classification of Accounts. From the net operating income thus ascertained shall be deducted 'uncollectible revenue,' and taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes, and the balance shall be deemed to be their net income taxable under this act."

The foregoing section relating to the basis of ascertaining the net income of railroads was supplemented by Chapter 35 of the Public Laws of 1921, as follows:

"Sec. 1. That in determining the taxable income of a corporation engaged in the business of operating a railroad under section two hundred and two of the act to raise revenue, in the case of a railroad located entirely within this State, the net operating income shall be increased or decreased to the extent of any credit or debit balance received or paid, as the case may be, on account of car hire; and when any railroad is located partly within and partly without this State, then said net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid, as the case may be, on account of car hire."

Section 203 of the Income Tax Act of 1921, as amended by Chapter 35, Public Laws of 1921, is as follows:

"Section 203. Such tax shall first be levied, collected and paid in the year 1922, and with respect to the net income received during the calendar year 1921, and annually thereafter."

126 Section 3 of Chapter 34, Public Laws of 1921, provides:

"No tax on any property in the State shall be levied for any of the uses of the State Government. The taxes hereinafter levied in this act are for the expenses of the State Government, the appropriations to its educational, charitable and penal institutions, pensions for Confederate Soldiers and widows, the interest on the debt of the State, an equalizing fund for public schools, and other specific appropriations made by law, and shall be collected and paid into the general fund of the State Treasurer."

"Section 306. Deductions.—In computing net income there shall be allowed as deductions:

"1. All the ordinary and necessary expenses paid during the income year in carrying on any trade or business, including:

"(a) As to individuals, wages of employees for services actually rendered in producing such income.

"(b) As to partnerships, wages of employees and a reasonable allowance for co-partners or members of a firm, for services actually rendered in producing such income, the amount of such salary allowance to be included in the personal return of the co-partner receiving same.

"(c) As to corporations, wages of employees and salaries of officers, if reasonable in amount, for services actually rendered in producing such income.

"2. Rentals or other payments required to be made as a condition of the continued use or possession, for the purposes of the trade of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

127 "3. All interest paid during the income year on indebtedness except interest on obligations contracted for the purchase of non-taxable securities. Dividends on preferred stock shall not be deducted as interest.

"4. Taxes for the income year, except taxes on income and war profits, and excess profits taxes, inheritance taxes, and taxes assessed for local benefit of a kind tending to increase the value of the property assessed.

"5. Dividends from stock in any corporation the income of which shall have been assessed and the tax on such income paid by the corporation under the provisions of this act: Provided, that when only part of the income of any corporation shall have been assessed under this *this* act only a corresponding part of the dividends received therefrom shall be deducted.

"6. Losses sustained during the income year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit.

"7. Debts ascertained to be worthless and charged off within the income year, if the amount has previously been included in gross income in a return under this act.

"8. A reasonable allowance for the depreciation and obsolescence of property used in the trade or business; and, in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion: Provided, that in computing the deductions allowed under this paragraph, the basis shall be the cost (including in the case of mines, oil and gas wells, and other natural deposits, the cost of development, not otherwise determined) and in the case of property acquired prior to January 1, 1921, the fair market value of the property (or the taxpayer's interest therein) on that rate shall be taken in lieu of cost up to that date. The reasonable allowances under this paragraph shall be made under rules and regulations to be prescribed by the Tax Commission. In the case of leases the deductions allowed may be equitably apportioned between the lessor and lessee.

"9. In the case of taxpayers who keep regular books of account, upon an accrual basis and in accordance with standard accounting practice, reserves for bad debts and for contingent liabilities, under such rules and restrictions as the Tax Commission may impose. If the Tax Commission shall, at any time, deem the reserve excessive in amount, it may restore such excess to income, either in a subsequent year or as a part of the income of the income year and assess it accordingly.

"10. Contributions or gifts made within the taxable year to corporations or associations operated exclusively for religious, charitable, scientific or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which enures to the benefit of any private stockholder or individual, to an amount not in excess of fifteen per centum of the taxpayer's net income as computed without the benefit of this subdivision.

"11. Resident individuals having an established business in another State, or investment in property in another State, may deduct the net income from such business or investment, if such business or investment is in a State that levies a tax upon such net income. The deductions authorized in this subsection shall in no case extend to any part of income of resident individuals from personal services, or mortgages, stocks, bonds, securities and deposits.

"12. In the case of a non-resident individual, the deductions allowed in this section shall be allowed only if, and to the extent that, they are connected with income arising from sources within the State; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the State shall be determined under rules and regulations prescribed by the State Tax Commission."

Complainant is engaged in operating an interstate railroad and keeps its accounts in accordance with the Standard Classification of

Accounts prescribed by the Interstate Commerce Commission and is required to pay an income tax under the appropriate part of Section 202 of the Income Tax Act or suffer the penalties prescribed in said Act.

Complainant respectfully shows the Court that the said Act is void as to complainant for the following reasons:

(a) Article 5, Section 3 of the Constitution of North Carolina authorizes the levy of a tax upon net incomes, and the statutory method prescribed in Section 202 for complainant and like corporations in order to arrive at net income results in the tax being levied on a sum which is not in truth and in fact net income, but includes a part of complainant's operating revenue in this:

Section 202 provides that railway corporations in the class of complainant shall first arrive at gross operating revenue within the State of its interstate business, and from this gross revenue shall deduct the following items:

130 (1) Proportionate average of operating expenses, as shown by the Interstate Commerce Commission Standard Classification of Accounts.

(2) Uncollectible revenue.

(3) Taxes paid in North Carolina for the income year, other than income taxes and war profits and excess profits taxes.

(4) An equal mileage proportion of car hire.

Plaintiff alleges that defendants, unless restrained by order of this Court, will, pursuant to the provisions of the Statutes in force in the State of North Carolina, levy upon and assess against it the income taxes for the year 1922 and certify such levy and assessment to the officers charged with the enforcement and collection thereof, amounting to a large sum in excess of \$3,000.00, to-wit the sum of \$71,522.06, whereas its true income tax should not be in excess of \$1,703.95, and that, unless said taxes are paid within the time fixed by the Statute, plaintiff will be subjected to heavy penalties and that the levy of such taxes will constitute a lien upon its property and thereby a cloud upon its title thereto, and that plaintiff will suffer other and irreparable damage etc., all of which will appear by reference to the allegations set out in its bill herein. The plaintiff's bill seeking an injunction, restraining defendants in the discharge of the official duties imposed by the Statute, is based upon the allegation that the sections of the Revenue Act of 1921, and especially upon those sections known as the "Income Tax Act" violate the Constitution of the State of North Carolina and of the United States in that among other reasons:

131 1st. The tax levied as directed by said Statute is not a tax on net incomes but is levied upon gross income, or real operating income and hence is repugnant to the State Constitution and to the Commerce Clause of the Federal Constitution.

2nd. The classification made by Section 202 of the Act, as to method of ascertainment of net income for plaintiff and other corporations within the designed class is arbitrary, without reasonable or practical basis and hence is repugnant to the Uniformity Clause, Art. 5, Sec. 3 of the State Constitution and the Equal Protection Clause of the Fourteenth Amendment to the Constitution of the United States.

That it is a violation of the State Constitution for the general property tax to be devoted to local purposes and the various exercise, privilege, franchise and income taxes to be devoted to State purposes.

That the income tax is invalid because it is levied in addition to property and franchise taxes. That the method of ascertaining the taxable income of plaintiff fixed or prescribed by Section 202 of the Act violates the provisions of Art. 5, Sec. 3 of the State Constitution and of the Fourteen- Amendment to the Federal Constitution, for that such method is not applied to such railroads or other public service corporation which do not operate their properties but have income only from rentals paid them by other companies to whom they lease their entire properties to be operated by the lessees.

It is pertinent, in view of the questions presented by the bills and answers and the prayer for injunctive relief to note the provisions of Section 700-701 of the Income Tax Act as amended by the 132 Act of 1921 creating the office known as Commissioner of Revenue, providing for and prescribing the procedure in applications for revision and appeal from assessments and levies of taxes against all persons or corporations having property in, or being liable for, tax in the State.

The Legislature, at its Special Session of 1921, made further provisions for refunding any taxes of any kind which have been through clerical error or misinterpretation or otherwise, collected or paid into the State Treasury in excess of the amount legally due the State and directing the State Auditor to issue his warrant for the amount so illegally collected to the person entitled thereto, upon certificate of the head of the department through which said taxes were collected or his successor in the performance of the functions of that department, with the approval of the Attorney General and the Treasurer to pay the sum out of any funds in the Treasury not otherwise appropriated.

Upon consideration of the bill and answer Exhibits and evidence it is

Adjudged and decreed that plaintiff is not entitled to have the defendants or either of them enjoined and restrained from the performance of the duties imposed upon them by the Statutes of North Carolina relating to the administration, assessing, levying and enforcement or collection of the income tax against plaintiff. That the bill be dismissed. That defendants recover their cost to be taxed by the Clerk.

This the 7th day of November, 1922.

At Wilson, North Carolina.

H. G. CONNOR,
U. S. District Judge.

Order Granting Thirty Day Stay.

Filed Nov. 18, 1922.

In the District Court of the United States for the Eastern District of
North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS, as Commissioner of Revenue of North Carolina, and
Others.

Income Tax Suit.

It is ordered that the defendants shall not proceed to enforce the collection of taxes involved in this litigation for the period of thirty days from the date of this order, to the end that complainant may take such action in the premises as it is advised to.

Dated at Wilmington, North Carolina this the 17th day of
November, 1922.

H. G. CONNOR,
U. S. Judge.

Filed Dec. 7th, 1922.

In the District Court of the United States for the Eastern District of
North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY, Plaintiff,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et als,
Defendants.

Notice of Appeal.

To the defendants in the above-entitled action and Honorable James
S. Manning, Attorney General of North Carolina, and Frank Nash
Assistant Attorney General, Solicitors for defendants:

You will please take notice that, on Wednesday, December 13th
1922, at 10.00 o'clock A. M., or as soon thereafter as counsel may

be heard, the above named plaintiff will apply to his Honor, Henry G. Connor, District Judge, at the United States Court Room, Raleigh, N. C., for an order allowing plaintiff to appeal to the Supreme Court of the United States in the above cause and granting a stay of proceedings until the appeal shall have been heard, passed upon and disposed of by the Supreme Court of the United States.

SOUTHERN RAILWAY COMPANY,
By W. M. HENDREN,
Attorney.

Service accepted this 7 day of December, 1922.

JAMES S. MANNING,
*Attorney General of North Carolina
and Solicitor for Defendants.*

135

Assignment of Errors.

Filed Dec. 13, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY, Plaintiff,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina et als.,
Defendants.

Assignments of Errors.

Now comes the plaintiff in the above entitled cause and, in connection with its petition for appeal from the decree entered November 13th, 1922, denying the application for a permanent injunction, files the following assignments of error:

The Court erred:

1. In decreeing that, upon consideration of the bill and answer, exhibits and evidence, plaintiff is not entitled to have the defendants or either of them enjoined and restrained from the performance of the duties imposed upon them by the statutes of North Carolina relating to the administration, assessing, levying and enforcement or collection of the income tax against the plaintiff.
2. In failing to hold that the plaintiff is entitled to the injunction prayed for in the bill of complaint, for that the income tax at-

tempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because said act is in violation of the Constitution of North Carolina and the Constitution of the United States, creates a discrimination against plaintiff and other railroad companies of similar character in favor of other corporations and individuals in that the said act in order to ascertain the taxable income allows other corporations and individuals certain deductions, many of which said deductions are not allowed to plaintiff and other railroad corporations of similar character.

3. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because, under the provisions of the Income Tax Act of 1921, and particularly Section 202, Section 300 and Section 306, all corporations which are required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, are required to pay a tax on their net income, which is defined by Section 300 as "the gross income of a taxpayer, less the deductions allowed by this act," whereas plaintiff and other railroads and public service corporations which are required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, are not allowed the deductions set forth in the said act, except "uncollectible revenue" and taxes paid in the State for the income year other than income taxes, war profits and excess profits taxes, and certain deductions for car hire, and plaintiff and other railroad companies and public service corporations of similar character referred to in Section 202 of the Income Tax Act of 1921 are denied large deductions which are granted other corporations, individuals and railroads not included in the provisions of Section 202, and particularly the deduction of interest paid during the income year, which results in discrimination against the plaintiff, in violation of the Constitution of North Carolina, and denies the plaintiff the equal protection of the law and deprives it of its property without due process of law in contravention of the Fourteenth Amendment of the Constitution of the United States.

4. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because said act does not operate equally and uniformly upon all taxpayers in similar circumstances, and that the plaintiff and other railroads and public service corporations, which are required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, have been arbitrarily selected and taxed upon a more burdensome basis and one that is different from that applied to corporations in general and to other corporations engaged in business similar to that of plaintiff, in violation of the Constitution of North Carolina and plaintiff is thereby denied

the equal protection of the law and is deprived of its property without due process of law in contravention of the Fourteenth Amendment of the Constitution of the United States.

5. In failing to hold that the plaintiff is entitled to an injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because said tax is not levied by a uniform rule as required by the Constitution of North Carolina, Article 5, Section 3, and the lack of uniformity works greatly to the detriment of plaintiff, in violation of said Article 5, Section 3, of the Constitution of North Carolina, and denies the plaintiff the equal protection of the law and deprives it of its property without due process of law, in contravention of the Fourteenth Amendment of the Constitution of the United States.

6. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because the classification of taxpayers for the purpose of fixing the income on which the tax shall be paid as made by the said Income Tax Act of 1921 is not based upon any reasonable ground, but is a mere arbitrary selection so far as plaintiff and railroad companies of similar character are concerned and so far as the corporations set forth in Section 202 are concerned, and was made for the purpose and has the result of imposing upon such railroad companies and corporations, including plaintiff, an unjust burden of taxation, in violation of the Constitution of North Carolina and denies the plaintiff the equal protection of the law and deprives it of its property without due process of law, in contravention of the Fourteenth Amendment of the Constitution of the United States.

138 7. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void, because the method of fixing plaintiff's taxable income as provided by Section 202 of the said Income Tax Act of 1921 violates the Constitution of North Carolina and the Constitution of the United States because it does not apply to railroads and public service corporations which derive their income from sources other than the operation of their property, which results in a lack of uniformity in the application of the income tax and in discrimination against plaintiff, and therein denies the plaintiff the equal protection of the law and deprives it of its property without due process of law, in contravention of the Fourteenth Amendment of the Constitution of the United States.

8. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax at-

tempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void, because the authority of the Legislature of North Carolina to tax incomes is derived from Section 3, Article 5, of the Constitution of North Carolina, and said section provides that only net incomes may be taxed, and in attempting to tax the "operating revenues" of plaintiff, the said act violates the Constitution of North Carolina and denies the plaintiff the equal protection of the law and deprives it of its property without due process of law, in contravention of the Fourteenth Amendment of the Constitution of the United States.

9. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because said act is violative of Article 5, Section 3, of the Constitution of

139 North Carolina, for that it does not levy upon railroads and other public service corporations named in said Section 202 a tax on net income, but levies a tax upon operating revenues derived from interstate and intrastate commerce, and does not permit the deductions necessary and incidental to the business of plaintiff and expended by it from said income in order to determine net income, and is in violation of the Interstate Commerce Clause (Section 8, Article 1) of the Constitution of the United States, in that it permits a tax as an income tax to be placed on gross income derived from interstate commerce, thereby burdening interstate commerce.

10. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because said act violates the Transportation Act of Congress and the Interstate Commerce Act, in that it seeks to prescribe a method of accounting by this interstate carrier, when said Acts of Congress have delegated the power to prescribe said accounting to the Interstate Commerce Commission and the said Commission has prescribed and directed that this plaintiff and other interstate carriers keep their accounts in accordance with the methods so prescribed by it.

11. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because the State of North Carolina, by its tax laws, permits the counties, cities, towns, townships and special taxing districts to levy taxes on the assessed value of plaintiff's property known as an ad valorem tax, which is based upon the whole property of plaintiff, tangible and intangible, and to this the tax laws of the State add a so-called franchise tax of one-tenth of one per cent. on the same assessed value and by the statutes hereinbefore referred to, the Legislature of North Carolina has levied and unless restrained the defendants in this action

140 will undertake to collect an additional tax characterized as an income tax of three per cent on plaintiff's net operating revenue, including revenue derived from interstate commerce, and plaintiff avers that this system of pyramiding taxes and the entire scheme of taxation amounts to a regulation of commerce between the states, because necessarily a tax of one-tenth of one per cent upon the tangible and intangible property of this plaintiff and a tax of three per cent upon its net operating revenue, including revenue derived from interstate commerce, are taxes upon interstate commerce, the property, tangible and intangible, having already been taxed at its full value, and plaintiff shows that this scheme of taxation levies a tax and burden upon the interstate commerce of plaintiff and violates the Commerce Clause of the Constitution of the United States, Section 8 of Article 1.

12. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because the penalties imposed for failure to comply with the Income Tax Act enacted by the Legislature of North Carolina are so excessive as to be violative of plaintiff's rights under the Constitution of the United States.

13. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because the plaintiff has no adequate remedy at law.

14. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void for that the levying of the income tax casts a cloud upon plaintiff's title.

W. M. HENDREN,
Attorney for Plaintiff.

Stipulation of Counsel as to Record.

Filed Dec. 13, 1922.

In the District Court of the United States for the Eastern District
of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.*Stipulation of Counsel as to Record.*It is stipulated and agreed by and between the parties to the above
entitled cause:That the Clerk, in making up the transcript of record on this
appeal from the decree of the District Court shall include:

Bill of complaint and exhibits thereto.

Application for interlocutory injunction.

Order on application for interlocutory injunction.

Notice of hearing on application for interlocutory injunction.

Answer.

Affidavit of J. H. Bridgers with exhibits.

Affidavit of Nathan O'Berry.

Affidavit of C. D. Bradham.

Affidavit of A. R. Turnbull.

Affidavit of J. C. Nelms.

Affidavit of J. C. Nelms.

Affidavit of J. C. Nelms.

Affidavit of F. C. Harding.

Affidavit of J. B. Duke.

Affidavit of M. S. Hawkins.

Affidavit of E. H. Kemper.

Affidavit of O. S. Thompson.

Affidavit of A. J. Maxwell.

Affidavit of R. O. Self.

Testimony and exhibits.

Certificate of Corporation Commission as to certain lumber cor-
porations, and others licensed as common carriers and engaged in
intrastate commerce in North Carolina.

Notice of appeal.

Petition for appeal.

Appeal bond.

Assignments of error.

Order allowing appeal and granting supersedeas and stay bond.
Citation.

Decree.

Stipulation of Counsel.

Agreement as to order setting down the case for hearing on merits.

Tender of amount admitted to be due and declination of the Commissioner of Revenue to receive the same.

Order of Judge granting thirty days' temporary stay, bearing date November 17, 1922.

It is further stipulated that the Clerk may use in preparing the record on appeal printed copies of all such pleadings, documents, affidavits, etc., as may be furnished by the parties hereto.

W. M. HENDREN,
Attorney for Complainant.
JAMES S. MANNING,
Solicitor for Defendants.

142 *Memorandum of Original Papers Certified Separately.*

Petition for Appeal filed December 13, 1922.

Appeal allowed Dec. 13, 1922.

Appeal Bond dated Dec. 13, 1922; penalty, \$1,000.00: Obligor: Southern Railway Company and United States Fidelity & Guaranty Company of Baltimore, Maryland: Conditioned for damages and costs.

Citation dated Dec. 13th, 1922; service accepted by James S. Manning, of Counsel for Defendants, Dec. 13th, 1922.

143 *Order to Transmit Record.*

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue, et als.

And thereupon it is ordered by the Court here that a transcript of the record and proceedings in said suit be transmitted to the United States Supreme Court at Washington, D. C., and the same is transmitted accordingly.

S. A. ASHE,
Clerk United States District Court.

Clerk's Certificate.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue, et als.

I, S. A. Ashe, Clerk, United States District Court, for the Eastern District of North Carolina, do hereby certify that the foregoing pages present a full, true and correct copy of the proceedings had and orders entered in that certain suit in equity pending in said Court, wherein Southern Railway Company is complainant and A. D. Watts, Commissioner of Revenue of North Carolina, and others, are defendants.

In testimony whereof, I have hereunto set my hand and affixed the seal of the said District Court at the Courthouse in Raleigh, State of North Carolina, this 20th day of December, 1922.

[Seal United States District Court, Eastern Dist. of N. C. at Raleigh.]

S. A. ASHE,

Clerk United States District Court.

145 In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY, Plaintiff,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et als,
Defendants.

Petition for Appeal and Stay.

To the Honorable H. G. Connor, District Judge of the United States for the Eastern District of North Carolina:

The Southern Railway Company, the above named plaintiff, feeling aggrieved by the order of the Court entered in the above entitled cause on the 13th day of November, 1922, refusing and denying the

injunction applied for in this cause restraining the defendants from collecting the income tax assessed against the plaintiff, hereby appeals to the Supreme Court of the United States from the said order upon the grounds set forth in the assignments of error filed herewith, and plaintiff prays that its appeal be allowed and that citation be issued as provided by law and that a transcript of the record, proceedings and documents upon which said appeal is based, duly authenticated, be sent to the Supreme Court of the United States under the rules of such Court in such cases made and provided.

And plaintiff further prays that the Court enter an order staying the collection of the said income tax and staying further proceedings by the defendants until the appeal herein prayed for shall have been heard, passed upon and disposed of by the Supreme Court of the United States.

SOUTHERN RAILWAY COMPANY,
By WM. HENDREN,
Attorney.

146 [Endorsed:] In Equity. No. 449. Southern Railway Company vs. A. D. Watts, Commissioner of Revenue of North Carolina, et als. Petition for appeal and stay. I certify that the within is entered and filed this day. Dec. 13, 1922. S. A. Ashe, Clerk.

147 In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.

Order Allowing Appeal and Granting Supersedeas and Stay.

This cause coming on to be heard upon the application of complainant, Southern Railway Company, for an appeal to the Supreme Court of the United States, and for a supersedeas and order staying and restraining the collection of the income tax involved in this suit and alleged to be illegal in the complaint filed herein, until the determination of the appeal in this cause now pending in the Supreme Court of the United States, and complainant being represented by W. M. Hendren, its attorney, and the defendants by their attorneys, Frank Nash, Assistant Attorney General of North Carolina, and George H. Brown, the appeal prayed for is hereby granted, appeal bond in the sum of \$1,000.00 to be filed.

And the Court being of the opinion that the status quo between the parties should be preserved pending such determination of appeal by the complainant to the Supreme Court of the United States:

It is, therefore, decreed and adjudged that defendants, their agents, servants and employees and each of them be and are hereby restrained from collecting or attempting to collect from complainant the income tax which is the subject matter of this suit, pending the determination of the appeal by the complainant in this cause now pending in the United States Supreme Court.

It is further ordered and decreed that complainant do give bond, bond, with good and sufficient surety, in the sum of \$10,000.00, to be approved by the Judge of the United States Court, or the Clerk of said Court, conditioned to pay to said defendants all of such income tax that may finally be determined in this cause to be legally due and payable by the complainant to the defendants.

Dated this 13 day of December, 1922.

H. G. CONNOR,

District Judge, Eastern District of North Carolina.

148 [Endorsed:] In Equity. No. 449. Southern Railway Company vs. A. D. Watts, Commissioner of Revenue of North Carolina, et als. Order allowing Appeal and Granting Supersedeas and Stay. I certify that the within is entered and filed this day. Dec. 13, 1922. S. A. Ashe, Clerk.

149 In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY, Plaintiff,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina; BENJAMIN R. Lacy, State Treasurer of North Carolina; Baxter Durham, State Auditor of North Carolina, and James S. Manning, Attorney General of North Carolina, Defendants.

the United States of America to A. D. Watts, Commissioner of Revenue of North Carolina; Benjamin R. Lacy, State Treasurer of North Carolina; Baxter Durham, State Auditor of North Carolina, and James S. Manning, Attorney General of North Carolina. Greeting:

Whereas, Southern Railway Company has lately appealed to the Supreme Court of the United States from a decree lately rendered in the District Court of the United States for the Eastern District of North Carolina, made in favor of you, the said Southern Railway Company, having filed the security required by law, you are therefore hereby cited to appear before the said Supreme Court of the

United States, at the City of Washington on the 13th day of January, next, to do and receive what may appertain to justice to be done in the premises.

Given under my hand at the City of Raleigh in the Fourth Circuit, this the 13 day of December, in the year of our Lord, One Thousand, Nine Hundred and Twenty-two.

H. G. CONNER,
*Judge of the District Court of the
United States for the Eastern
District of North Carolina.*

Service accepted this 13 day of December, 1922.

JAMES S. MANNING,
Of Counsel for Defendants.

150 [Endorsed:] In Equity. No. 449. Southern Railway Company vs. A. D. Watts, Commissioner of Revenue of North Carolina, et als. Citation & Acceptance of Service. I certify that the within is entered and filed this day. Dec. 13, 1922. S. A. Ashe, Clerk.

151 In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY, Complainant,
vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.

Know all men by these presents that Southern Railway Company, as principal, and United States Fidelity & Guaranty Company of Baltimore, Maryland, as surety, acknowledge themselves indebted to the defendants, A. D. Watts, Commissioner of Revenue of North Carolina, Benjamin R. Lacy, State Treasurer of North Carolina, Baxter Durham, State Auditor of North Carolina, and James S. Manning, Attorney General of North Carolina, in the above entitled cause in the sum of One Thousand (\$1,000.00) Dollars, to the payment of which we bind ourselves, our successors and assigns.

In witness whereof, Southern Railway Company, principal, has caused these presents to be executed by W. M. Hendren, its Attorney, and United States Fidelity & Guaranty Company of Baltimore, Maryland, the surety, has caused these presents to be executed by W. B. Jones, its Attorney in Fact, duly appointed and authorized to execute surety bonds, and its corporate seal to be hereto affixed.

The condition of the foregoing bond is such that:

Whereas, Southern Railway Company, the above named plaintiff, instituted a suit in the United States District Court for the Eastern

District of North Carolina against A. D. Watts, and other defendants named in said bill, in which said cause a permanent injunction was asked to be granted against the defendants, enjoining the collection of the income tax claimed to be due the State of North Carolina as set out in said bill upon the grounds as set forth in said bill; and,

Whereas, upon the hearing of said application for a permanent injunction, the prayer of the plaintiff was denied and the bill dismissed; and,

Whereas, the plaintiff has obtained an appeal to the Supreme Court of the United States and a citation has been issued to the defendants citing and admonishing them to be and appear in the Supreme Court of the United States on January 13th, 1923.

Now, the condition of the above obligation is such that, if the said Southern Railway Company shall prosecute its appeal to effect and answer all damages and costs if it fail to make its plea good, then the above obligation to be void; else to remain in full force and effect.

In Witness Whereof, Southern Railway Company, principal, has caused these presents to be executed by W. M. Hendren, its Attorney and United States Fidelity & Guaranty Company of Baltimore, Maryland, Surety, has caused these presents to be executed by W. B. Jones, its Attorney in Fact, thereunto duly authorized and empowered so to do, and its corporate seal to be hereto affixed, this the 13 day of December, 1922.

SOUTHERN RAILWAY COMPANY,
By W. M. HENDREN,

Its Attorney.

UNITED STATES FIDELITY &
GUARANTY COMPANY, OF BAL-
TIMORE, MARYLAND,

By WM. B. JONES,
Attorney in Fact.

[Seal of the United States Fidelity & Guaranty Company.]

Approved:

H. G. CONNOR,

*Judge of the United States District
Court for the Eastern District of
North Carolina.*

153 [Endorsed:] In Equity. No. 449. Southern Railway Company vs. A. D. Watts, Commissioner of Revenue of North Carolina, et als. Appeal Bond. I certify that the within is entered and filed this day. Dec. 13, 1922. S. A. Ashe, Clerk.

Endorsed on cover: File No. 29306. E. North Carolina D. C. U. S. Term No. 756. Southern Railway Company, Appellant, vs. A. D. Watts, and A. D. Watts as Commissioner of Revenue of the State of North Carolina, et al. Filed December 22d, 1922. File No. 29306.

FILED

JAN 9 1923

WM. R. STANSBURY
CLERK

IN THE
SUPREME COURT OF THE UNITED STATES.

No. 756.

SOUTHERN RAILWAY CO.

vs.

A. D. WATTS, COMMISSIONER OF REVENUE OF NORTH
CAROLINA, ET ALS.

No. 727.

NORFOLK SOUTHERN R. R. CO.

vs.

SAME.

No. 724.

ATLANTIC COAST LINE R. R. CO.

vs.

SAME.

No. 744.

SEABOARD AIR LINE R. R. CO.

vs.

SAME.

Then come the defendants, representing the State of North Carolina and move this Honorable Supreme Court:

That the above causes, now docketed and being at issue in this court be advanced and set down for argument at as early a date as is convenient to the court.

These causes involve a different subject-matter from those between same parties, decisions in which were handed down on January 2, 1923, by this court.

These cases involved the validity of the franchise and *ad valorem* property taxes levied by the State of North Carolina. The cases now before the court and sought to be advanced to an early hearing involve the validity of the income taxes levied and assessed against the Plaintiffs, Railroad Companies. This tax was sustained in the lower Federal Court and an appeal taken by Plaintiffs to this court. An injunction or stay pending the appeal has been granted and the State has been unable to collect any part of said income tax for two years past. It is essential to the support and maintenance of the State that these taxes be paid as soon as possible as the State levies no property tax for its support depending on franchise, privilege and income taxes entirely. To delay the hearing of these causes for several years would result in great inconvenience and damage to the State government.

Wherefore your honors are earnestly petitioned to advance these causes and set them down for hearing at a date as early as is consistent with the convenience of the court.

JAS. S. MANNING,

Atty. General State of North Carolina.

GEO. H. BROWN,

Of Counsel.

JANUARY 8, 1923.

[Endorsed:] Southern Ry. Co., Norfolk Southern Ry. Co. and other R. R. Cos. *vs.* A. D. Watts, Comsnr. Revenue of State of North Carolina. Motion to advance.

MAR 19 1923

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No. 727.

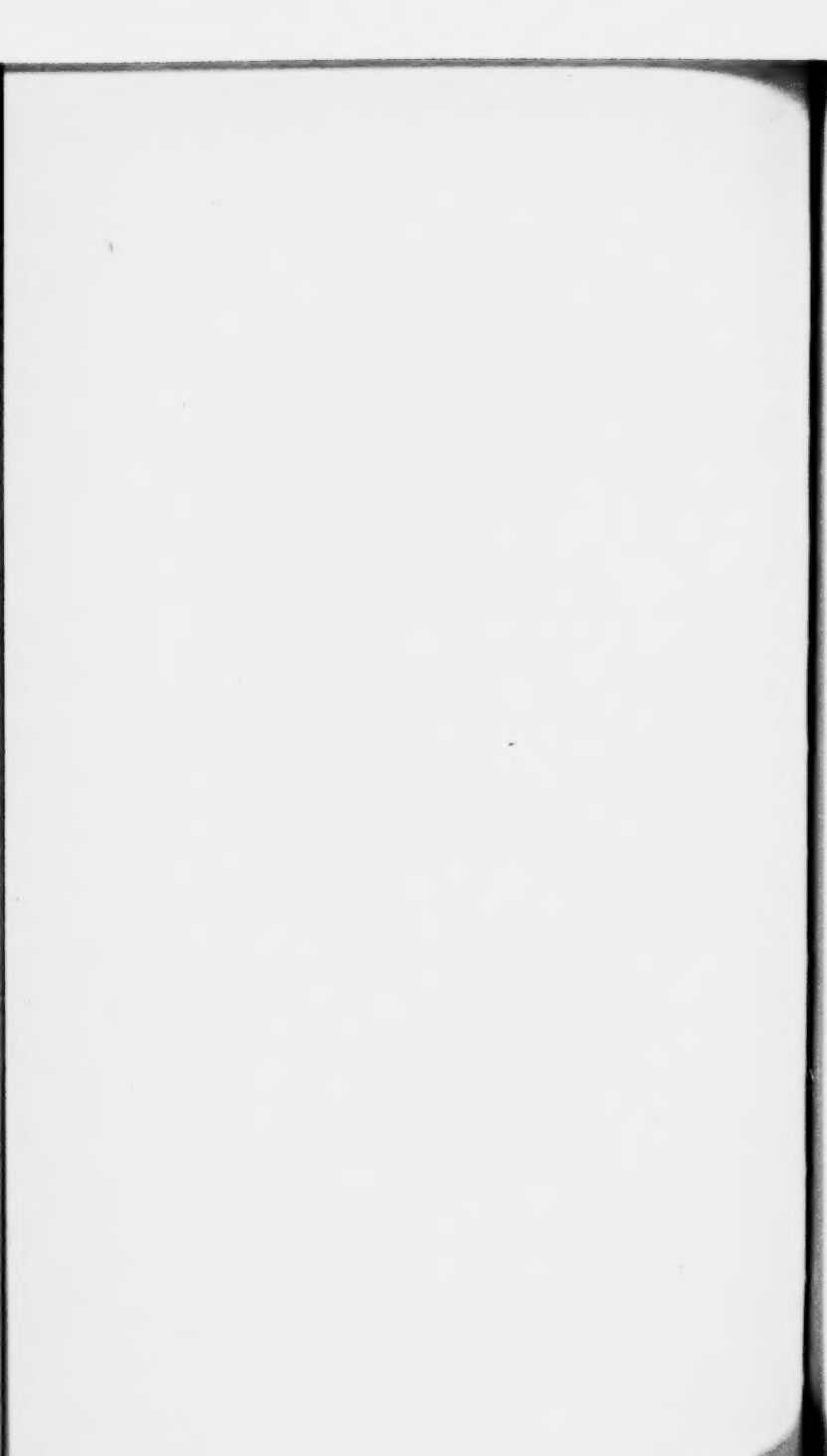
NORFOLK SOUTHERN RAILROAD COMPANY, Appellant

vs.

A. D. WATTS, Individually and as Commissioner of Revenue
of North Carolina, et al., Appellees.

**Brief of Appellants in Support of Motion to Sub-
stitute R. A. Doughton, Commissioner of Reve-
nue of North Carolina, for A. D. Watts, Commis-
sioner of Revenue of North Carolina.**

S. R. PRINCE,
THOS. W. DAVIS,
JAMES F. WRIGHT,
W. B. RODMAN,
MURRAY ALLEN,
Counsel for Appellant.



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**Brief of Appellants in Support of Motion to Sub-
stitute R. A. Doughton, Commissioner of Reve-
nue of North Carolina, for A. D. Watts, Commis-
sioner of Revenue of North Carolina.**

This is a suit to enjoin public officers of North
Carolina from enforcing the Income Tax Act of
North Carolina and to have the Income Tax Act
of North Carolina decreed invalid for the reasons

assigned. One of the original defendants was A. D. Watts, at that time Commissioner of Revenue of North Carolina, and the other defendant was and is James S. Manning, Attorney General of North Carolina. As shown by the motion to substitute, A. D. Watts resigned the office of Commissioner of Revenue on January 29, 1923, and on the same day his successor, R. A. Doughton, was appointed and confirmed. The prayer of the motion, consented to by R. A. Doughton, is to substitute R. A. Doughton, Commissioner of Revenue, for A. D. Watts, Commissioner of Revenue.

This Court, in the recent cases of "*Gorham Manufacturing Company vs. Wendell, et al.*" (decided February 19, 1923), "*City of Boston vs. Jackson*" (decided December 4, 1922), and "*Irwin vs. Wright*," 258 U. S. 219, has stated the rule. It is—

1. Where individuals are sued as members of a Board or Commission having a continuing existence the suit does not abate on retirement of the individuals, but may be continued, substituting their successors in office.

2. A suit to enjoin a public officer from enforcing a statute is personal and, in the absence of a statute, the action abates as to him upon his retirement from office.

3. Where the successor in office consents to the substitution and there is any basis at all under the State law or practice for substitution of successors in office, this Court will avail thereof and permit the substitution.

The Income Tax Act of North Carolina (Chap-

ter 34, p. 203, Public Laws of North Carolina, Session 1921) attacked in this suit, provided for the return to be made to the Tax Commission and for the tax to be paid to the Tax Commission and for the law to be administered by the Tax Commission. The Tax Commission was created by Chapter 38, p. 225 of the Public Laws of North Carolina, Session 1921. The Legislature of North Carolina passed an Act (Chapter 40, p. 288, Public Laws of North Carolina, Session 1921) entitled "An Act to Transfer the Powers and Duties of the State Tax Commission to the State Department of Revenue." This Act provided in Section 1 as follows:

"Section 1. From and after the first day of May, one thousand nine hundred and twenty-one, all the powers and duties imposed by any act or law, including Revenue and Machinery Acts, enacted by the present session of the General Assembly, upon the State Tax Commission, shall be transferred to and imposed upon a department to be known as the State Department of Revenue, created by this act, to be administered by the Commissioner of Revenue, to be appointed as provided in this act. All such powers and duties, except as otherwise provided herein, shall devolve upon the Commissioner of Revenue, and wherever in the revenue laws of the State the words 'State Tax Commission' are used such words shall, after May first, one thousand nine hundred and twenty-one, be held to mean Commissioner of Revenue, except as otherwise provided in this act."

This was the status of the law at the time of the

institution of the suit against A. D. Watts, individually and as Commissioner of Revenue. The Income Tax Act, as originally enacted, was to be administered by the State Tax Commission, but by the later enactment the duties of the State Tax Commission were transferred to the department to be known as the State Department of Revenue, to be administered by the Commissioner of Revenue. We therefore contend that under the status of the legislative enactments of North Carolina above set forth, the Commissioner of Revenue is the administrative officer of the State Department of Revenue, a continuing department, and therefore Watts sued as Commissioner of Revenue comes under the ruling of this Court, above set forth, in which an individual is sued as a member of a Board or Commission. The Department of Revenue has a continuing existence and the retirement of the individual Watts does not abate the suit, but his successor in office, Doughton, may be substituted. A. D. Watts had, of course, no personal interest in the matter. The suit was against him as Commissioner of Revenue because he was the statutory officer directed to enforce what Appellant thought to be an unconstitutional statute. The error complained of was not on account of the exercise of any discretion or judgment on his part, but merely the enforcement of the law as written.

Section 461 of the Consolidated Statutes of North Carolina, 1919, provides:

“Abatement of actions. 1. No action abates

by the death, marriage, or other disability of a party, or by the transfer of any interest therein, if the cause of action survives, or continues. In case of death, except in suits for penalties and for damages merely vindictive, or in case of marriage or other disability of a party, the court, on motion at any time within one year thereafter, or afterwards on a supplemental complaint, may allow the action to be continued, by, or against, his representative or successor in interest. In case of any other transfer of interest, the action shall be continued in the name of the original party, or the court may allow the person to whom the transfer is made to be substituted in the action."

This is in substance the same as the Section of the Arizona Code which this Court had before it in the case of *Irwin v. Wright, supra*, construing which this Court held the substitution could not be made. That ruling would control here unless said statute has been construed by the North Carolina Court or the practice in that State permits such substitution. The Supreme Court of North Carolina has sufficiently ruled on the statute to permit the substitution. We may say, that which we believe will not be contradicted, namely, that the practice is to permit such substitution.

The Supreme Court of North Carolina, in the case of *Davenport v. McKee*, 98 N. C. 500, which was a suit brought by the State on relation of Davenport, Treasurer, against the defendant Sheriff of Gaston County, had before it a contention that

the action had abated by reason of the going out of office of the Treasurer who brought the suit and the induction of a successor in office while it was pending. The Court said:

“The action is brought by the State on bonds executed to it, and the relator is but an agent in seeking to recover the moneys due; and besides, a contingency of a transfer of interest pending a suit is provided for in Section 188 of The Code, which declares how a cause may be continued, except a suit for penalties and vindictive damages, in case of the death, marriage, or other disability of a party, and that ‘in case of any other transfer of interest the action shall be continued in the name of the original party, or the Court may allow the person to whom the transfer is made to be substituted in the action.’ The motion was properly refused.”

Section 188 of the Code referred to in the above quotation is the same as Section 461 of the present Code of North Carolina, above set forth. The case is cited to show that the Court held that the induction of a successor in office was a transfer of interest within the meaning of Section 461. The North Carolina Court having held said Section applies to a successor in office and the Section plainly allowing the action to be continued “*by or against*, his representative or successor in interest” shows that the North Carolina Court would hold Section 461 applied to the kind of case we have in

hand and allow the substitution. This being true, then the general rule announced by this Court applies and the substitution should be allowed because of the State Court's construction of a State statute permitting the same.

Section 505 of the Income Tax Act provides that the tax shall become a debt due the State of North Carolina from the time it is payable. Section 506 provides that action for recovery of the tax may be brought at any time by the Attorney General of the State at the instance of the Tax Commission (now the Commissioner of Revenue) in the name of the State, to recover the amount of any taxes, penalties, and interest due under this Act.

Paragraph 5 of Section 600 provides that "any person who, without fraudulent intent, fails to pay any tax * * * within the time required by or under the provisions of this Act, shall be liable to a penalty of not more than one thousand dollars, to be recovered by the Attorney General, in the name of the people, in action in any Court of competent jurisdiction."

The Attorney General of North Carolina, upon whom are placed the duties to collect the tax and to prosecute for failure to pay by the above Sections of the Act, is a party defendant to this action, so that at all events the Court below erred in refusing the injunction and dismissing the bill as to the Attorney General, and we submit that the

case can not abate as to him, and for the reasons given above the substitution of R. A. Doughton should be permitted.

Respectfully submitted,

S. R. PRINCE,
THOS. W. DAVIS,
JAMES F. WRIGHT,
W. B. RODMAN,
MURRAY ALLEN,
Counsel for Appellant.

FILED

MAR 19 1923

WM. R. STANSBURY
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IN THE
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OCTOBER TERM, 1922.

No. 756.

SOUTHERN RAILWAY COMPANY,
Appellant,
vs.

A. D. WATTS, INDIVIDUALLY AND AS
COMMISSIONER OF REVENUE OF
NORTH CAROLINA, ET AL., Appellees.

**Motion for Leave to Substitute R. A. Doughton,
Commissioner of Revenue of North Carolina, for
A. D. Watts, Commissioner of Revenue of North
Carolina.**

S. R. PRINCE,
W. M. HENDREN,
Counsel for Appellant.

L. E. JEFFRIES,
Of Counsel.

March 19, 1923.

IN THE
Supreme Court of the United States

OCTOBER TERM, 1922.

No. 756.

SOUTHERN RAILWAY COMPANY,
Appellant,

vs.

A. D. WATTS, INDIVIDUALLY AND AS
COMMISSIONER OF REVENUE OF
NORTH CAROLINA, ET AL., Appellees.

Comes the Appellant, Southern Railway Company, and moves the Court to substitute R. A. Doughton as one of the Appellees in this cause in place of A. D. Watts, and, for grounds of said motion, respectfully shows:

A. D. Watts, individually and as Commissioner of Revenue of the State of North Carolina, together with James S. Manning, Attorney General of North Carolina, were the original defendants herein. A. D. Watts resigned the office of Com-

missioner of Revenue on January 29, 1923, and was on January 29, 1923, succeeded in office by R. A. Doughton, who now holds said office.

Wherefore, Appellant prays that R. A. Doughton be substituted for A. D. Watts.

S. R. PRINCE,
Attorney for Appellant.

The undersigned, James S. Manning, Attorney General of the State of North Carolina, and representing R. A. Doughton, the present Commissioner of Revenue of North Carolina, consents for said R. A. Doughton to the substitution hereinabove moved for.

JAMES S. MANNING,
Attorney for R. A. Doughton.

MAR 23 1923

W. M. B. STANBURY

CLERK

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No. 756.

SOUTHERN RAILWAY COMPANY, *Appellant*

vs.

A. D. WATTS, ET AL., *Appellees.*

INCOME TAX SUIT.

BRIEF FOR APPELLANT.

S. R. PRINCE,

W. M. HENDREN,

Counsel for Appellant.

L. E. JEFFRIES,

Of Counsel.

March 10, 1923.

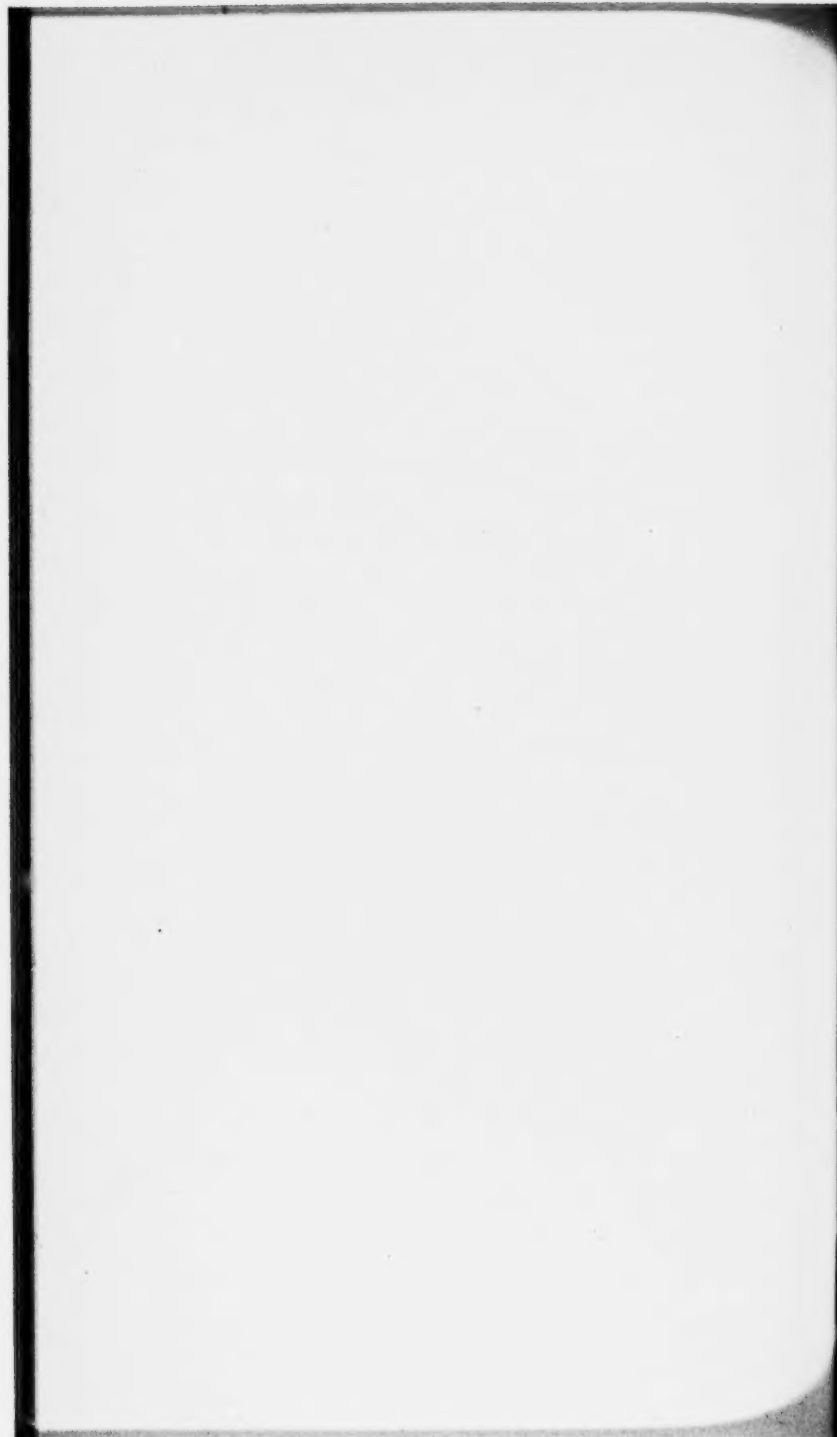


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Supreme Court of the United States

OCTOBER TERM, 1922.

No. 756.

SOUTHERN RAILWAY COMPANY, *Appellant*
vs.

A. D. WATTS, ET AL., *Appellees.*

BRIEF FOR APPELLANT.

STATEMENT OF THE CASE

This is a suit by a Virginia corporation against certain income tax levying, collecting, and enforcing officers of the State of North Carolina. The amount involved is fifty-seven thousand dollars. In this suit the construction of the Constitution of the United States is in question and the case is before this Court on direct appeal under Section 238 of the Judicial Code from a final decree of the District Court of the Eastern District of North Carolina dismissing the bill, without opinion.

Article 5, Section 3, of the Constitution of North Carolina (record, page 2) provides that the General Assembly may tax net incomes. Under this authority, the Legislature of North Carolina at its regular Session, 1921, enacted an Income Tax Law (Chapter 34, Public Laws of North Carolina,

1921), levying a tax of three per cent on the entire net income of all corporations. This Income Tax Law in Section 101 states the purpose of the law to be to impose a tax upon net income. Section 201 is the specific Section dealing with the income tax on railroads (4). This latter Section was amended by Chapter 35 of the Public Laws of 1921. Section 306 of the Income Tax Act (5) set forth the deductions allowed in computing net income. This Section did not apply to railroads.

Section 202 and the amendment (Chapter 35, Public Laws, 1921) provides that railway corporations in the class of complainant, required to keep accounts according to the Standard Classification of Accounting of the Interstate Commerce Commission, shall first arrive at gross operating revenue within the State, including an equal mileage porportion within the State of its interstate business, and from this gross revenue shall deduct the following items:

- (1) Proportionate average of operating expenses, as shown by the Interstate Commerce Commission Standard Classification of Accounts.
- (2) Uncollectible revenue.
- (3) Taxes paid in North Carolina for the income year, other than income taxes and war profits and excess profits taxes.
- (4) An equal mileage proportion of car hire.

“and the balance shall be deemed to be their net income taxable under this Act.”

The Commissioner of Revenue sent to Appellant

a form for the making out of this return (14) and claimed and demanded a tax under the law, as shown by said form, amounting to \$71,522.06. The Railway claimed that this tax was not levied on its true net income, in that under the Standard Classification of Accounts, promulgated by the Interstate Commerce Commission, in order to arrive at net income, the following deductions from its gross income should be made, in addition to those set forth in Section 202, namely:

- Equipment Rents (including Car Hire, Rent of Locomotives, Rent of Passenger Cars, etc.);
- Joint Facility Rents;
- Rent for Leased Roads;
- Miscellaneous Rents;
- Separately Operated Properties—Loss;
- Interest on Funded Debt;
- Interest on Unfunded Debt;
- Amortization of Discount on Funded Debt;
- Maintenance of Investment Organization;
- Income Transferred to Other Companies;
- Miscellaneous Income Charges.

Making said deductions according to the Classification of Accounts of the Interstate Commerce Commission, and as set forth in the bill (15), showed that the tax on the net income would be \$16,641.73. Appellant claimed further that the Interstate Commerce Commission permitted other deductions, as set forth in Exhibit "C" to the bill (15-16), which would make the income tax on net income \$13,703.95. A return on that basis was

tendered the Commissioner of Revenue, within the sixty days extension allowed from the initial due date, and declined by him (82-3). The further material facts will appear later in this brief.

There was an application filed for an interlocutory injunction (16). This did not come to a hearing, it being agreed that no action would be taken seeking to enforce the collection pending the litigation, as a result of which an order was entered setting the case down for final hearing on its merits (18). The case was heard on the answer, affidavits, and testimony and the Court entered final decree dismissing the bill (87 to 93). The appeal is from this decree.

The assignment of errors is found in the record, pages 95 to 99. The assignments of error insisted upon are numbered 2, 4, 5, 8, 9 and 10, which, in substance, raise the following questions of invalidity of the law.

(1) The tax is on a part of the gross income from interstate commerce and violates the Commerce Clause of the Federal Constitution and Section 3, Article 5, of the North Carolina Constitution, which empowers the State to tax only *net* income.

(2) The Law is void because it contains an unreasonable classification upon no fair substantial difference, and its enforcement denies Appellant the equal protection of the law guaranteed it under the Fourteenth Amendment to the Constitution of the United States and the Uniformity Section of the North Carolina Constitution.

(3) The State has the power to tax only net income from interstate commerce, as defined by the Interstate Act, as amended.

BRIEF.

Jurisdiction.

This suit, between citizens of different States, involving in excess of three thousand dollars, and raising in good faith the construction of the Commerce Clause of the Constitution of the United States and the Fourteenth Amendment to the Constitution of the United States, and the non-payment of the income tax creating a lien upon the property of the Appellant and subjecting the property to execution and sale, and subjecting Appellant to heavy penalties for non-payment, gives the Federal Equity Court jurisdiction unless there was a plain, adequate remedy at law.

Wallace v. Hines, 253 U. S. 66-67;
Shaffer v. Carter, 252 U. S. 37, 46;
Greene v. L. & I. R. R., 244 U. S. 499, 506;
Union Pac. v. Colorado, 247 U. S. 282, 286;
Southern Railway v. Watts, decided Jan. 2, 1923.

There is no plain, adequate, complete remedy at law.

The case of *Shaffer v. Carter* was a suit in equity to restrain the enforcement of a tax assessed under the Income Tax Law of Oklahoma. The Court said:

"As ground for resorting to equity, the bill alleges that plaintiff is the owner of various oil and gas mining leases covering lands in Creek County, Oklahoma, and that the lien assessed thereon by virtue of the levy and tax warrant creates a cloud upon his title. This entitles him to bring suit in equity (citing many cases), unless the contention that he has a plain, adequate, and complete remedy at law be well founded."

Shaffer v. Carter, 252 U. S. 37, 46.

The Income Tax Act provides in part:

"Sec. 403. *Time and place of filing returns.* Returns shall be in such forms as the Tax Commission may from time to time prescribe and shall be filed with the Tax Commission, at its main office or at any branch office which it may establish, on or before the fifteenth day of March in each year," etc.

It further provides for payment at the time of filing of the return:

"Sec. 500. *Time and place of payment of tax.* 1. The full amount of the tax payable, as the same shall appear from the face of the return, shall be paid to the Tax Commission at the office where the return is filed at the time fixed by law for filing the return," etc.

The method of collection of the tax in case of non-payment is found in Section 504:

"Sec. 504. *Warrant for the collection of taxes.* If any tax imposed by this act or any

portion of such tax be not paid within sixty days after the same becomes due, the Tax Commission shall issue an order under its hand and official seal directed to the sheriff of any county of the State, commanding him to levy upon and sell the real and personal property of the taxpayer, found within his county, for the payment of the amount thereof, with the added penalties, interest and the cost of executing the same and to return to the Tax Commission the money collected by virtue thereof by a time to be therein specified, not less than sixty days from the date of the order. The said sheriff shall thereupon proceed upon the same in all respects, with like effect, and in the same manner prescribed by law in respect to executions issued against property upon judgments of a court of record and shall be entitled to the same fees for his service in executing the order, to be collected in the same manner. If an order be returned not satisfied in full, the Tax Commission shall have the same remedies to enforce the claim for taxes against the taxpayer as if the State had recovered judgment against the taxpayer for the amount of the tax."

Among the penalties provided is that found in Section 600. Paragraph 2 of this Section reads as follows:

"If any taxpayer fails voluntarily to file a return of income or pay a tax, if one is due, within sixty days of the time required by or under the provisions of this act, the tax shall be doubled, and such doubled tax shall be increased by one per cent for each month or

fraction of a month from the time the tax was originally due to the date of payment.”

The penalty for neglect without fraudulent intent is found in paragraph 5 of Section 600 and is as follows:

“Any person who, without fraudulent intent, fails to pay any tax or to make, render, sign or verify any return, or to supply any information, within the time required by or under the provisions of this act, shall be liable to a penalty of not more than one thousand dollars, to be recovered by the Attorney General, in the name of the people, by action in any court of competent jurisdiction.”

Under the head of revision and appeal, the Income Tax Law provides:

“Sec. 700. *Revision by Tax Commission.* A taxpayer may apply to the Tax Commission for revision of the tax assessed against him, at any time within one year from the time of the filing of the return or from the date of the notice of the assessment of any additional tax. The Tax Commission shall grant a hearing thereon, and if, upon such hearing, it shall determine that the tax is excessive or incorrect, it shall resettle the same according to the law and the facts and adjust the computation of tax accordingly. The Tax Commission shall notify the taxpayer of its determination and shall refund to the taxpayer the amount, if any, paid in excess of the tax found by it to be due. If the taxpayer has failed, without good cause, to file a return within the time pre-

scribed by law, or has filed a fraudulent return, or, having filed an incorrect return, has failed, after notice, to file a proper return, the Tax Commission shall not reduce the tax below double the amount for which the taxpayer is found to be properly assessed.

“Sec. 701. *Appeal.* Any taxpayer may file formal exceptions to any finding by the State Tax Commission with respect to his taxable income, and upon such exceptions being overruled, any such taxpayer shall have the right, upon the payment of the amount of tax found by the State Tax Commission to be due, and upon filing bond for costs in the sum of two hundred dollars, to have the record in such case certified to the Superior Court of the county in which the taxpayer resides, or has his principal place of business, within thirty days after notice by the Tax Commission of its determination, given as provided in section 700 of this act. Thereupon, appropriate proceedings shall be had and the relief, if any, to which the taxpayer may be found entitled may be granted and any taxes, interest or penalties paid, found by the Court to be in excess of those legally assessed, shall be ordered refunded to the taxpayer, with interest from time of payment.”

The Legislature further provided by Special Act of December 19, 1921, for the refund of illegally collected taxes as follows:

“Section 1. Whenever taxes of any kind are or have been through clerical error, or mis-

interpretation of the law, or otherwise, collected and paid into the State Treasury in excess of the amount legally due the State, the State Auditor shall issue his warrant for the amount so illegally collected, to the person entitled thereto, upon certificate of the head of the department through which said taxes were collected or his successor in the performance of the functions of that department, with the approval of the Attorney-General, and the Treasurer shall pay the same out of any funds in the treasury not otherwise appropriated: Provided, demand is made for the correction of such error or errors within two years from the time of such payment: Provided further, that claims which have arisen within the five years next preceding the ratification of this act shall be presented and made within two years from the ratification of this act."

In considering whether the foregoing provides a plain, complete, and adequate remedy at law, we should consider also Section 7979 of the Consolidated Statutes of North Carolina, which is a subsection under the general statutes of North Carolina dealing with the collection of taxes. That Section provides in part:

"7979. *Remedy of taxpayer for unauthorized tax.* Unless a tax or assessment, or some part thereof, be illegal or invalid, or be levied or assessed for an illegal or unauthorized purpose, no injunction shall be granted by any court or judge to restrain the collection thereof in whole or in part, nor to restrain the sale of any property for the nonpayment thereof;"

Said Section also provided for payment under protest and demand within thirty days and suit thereafter against the County.

The North Carolina Supreme Court had before it in the case of *Range Company v. Carver* an application for an injunction to restrain a sheriff from collecting a tax. The defendant denied plaintiff's right to proceed by injunction under Section 76 of the Machinery Act of 1895, now Section 7979. The Court did not agree with defendant that an injunction would not lie and held:

"It was agreed that plaintiff might proceed by injunction, unless he is prevented by this section, and it is true that this section does not profess to prohibit the issuance of injunctions against the collection of public taxes, except in certain cases, and it seems to us that the exception is about as broad as the prohibition, and about all the effect it has is to give an additional remedy, which is left to the discretion of the party to pay the tax and then bring an action to recover the money back. But whether the exception is as broad as it seems to us or not, it in express terms excepts from the inhibition of injunction taxes that are 'illegal or invalid,' and that is what the plaintiff alleges in this case—that they are 'illegal and invalid'; and this question of jurisdiction being disposed of, the matter comes to be considered upon its merits."

Range Co. v. Carver, 118 N. C. 328, at 330.

The North Carolina Supreme Court in the case of *Purnell v. Page*, 133 N. C. 125, in considering

the question of whether an injunction would lie to restrain the collection of an income tax under a former law, held at page 129:

“As to the other point, whether the plaintiff can maintain an injunction against the sale of his property under an illegal tax, or must pay the tax under protest and sue to recover it back, it is equally well settled that he can pursue either remedy. *Range Co. v. Carver*, 118 N. C., 331; *Armstrong v. Stedman*, 130 N. C. 217; *Brinkley v. Smith*, 130 N. C. 224, hold that under the language of the statute ‘injunctive relief may be invoked by a taxpayer when the tax is *invalid or illegal*.’ ”

The foregoing North Carolina cases are cited to show that under the general policy of the State of North Carolina and its decisions a taxpayer is allowed his election of remedies. He may either pay under protest and sue to recover or he may enjoin the collection of a tax, if it be claimed to be non-collectible due to its illegality or invalidity.

The general rule, as set forth in the *Carter* case, *supra*, is that the remedy at law must be plain, adequate and complete. In order to oust the equity jurisdiction, the remedy must be as practical and as efficient to the ends of justice and its prompt administration as the remedy in equity. This Court, in the case of *Gormley v. Clark*, 134 U. S. 338, stated the rule to be:

“The jurisdiction in equity attaches unless the legal remedy, both in respect to the final

relief and the mode of obtaining it, is as efficient as the remedy which equity would afford under the same circumstances, *Kilbourn v. Sunderland*, 130 U. S. 505, 514;”

That statement of the rule has been concurred in by the Supreme Court of North Carolina in the case of *Sumner v. Staton*, 151 N. C. 198, 201.

It will be noted from the foregoing Sections of the Income Tax Act that the tax is payable at the time and place of making the return and that if not paid then under Section 504 the Tax Commission (now the Commissioner of Revenue) may direct the Sheriff to levy and sell the property of the taxpayer in the manner prescribed by law in respect to executions upon a judgment. It is not clear that this procedure may not be had even though the taxpayer asks a revision of his tax under Section 700. The legal remedy must be certain and plain. There must be no doubt about it. We submit there is serious doubt as to whether Sections 700 and 701 apply to a case of this kind, where the law is claimed to be unconstitutional. An analysis of Sections 700 and 701, we think, will convince that they were not intended to apply to a claim of the invalidity of a tax upon constitutional grounds because—

(1) Of the anomaly of submitting to an administrative officer of the State a constitutional question arising out of the want of power of the State to levy a tax;

(2) The sections on their face are applicable

only to cases where the tax has been erroneously assessed or calculated. The application is "for revision of the tax" and the relief to be granted is to "resettle the same" if the tax is found to be "excessive or incorrect."

There is likewise room for the contention that the Act of the Special Session of 1921 was not intended to nor does it qualify the right given under Section 7979 of the Consolidated Statutes to enjoin the enforcement of a tax alleged to be void for constitutional reasons. The language of this statute can be fulfilled by limiting its scope and purpose to be to supply a remedy where a tax payable to the State is assessed because of a "clerical error or misinterpretation of the law."

Unless the words "or otherwise" makes this statute applicable to a tax claimed to be void upon constitutional grounds, it is clear that this statute does not afford the plaintiff any remedy at all. Is it not a permissible construction to say that the words "or otherwise" mean something that is akin to "clerical error or misinterpretation of the law"?

The tax in this case is claimed to be void, so there is nothing due at all. There can then be no "excess" of an amount legally due the State.

That the draftsman of this Act did not have in mind a case where the tax is asserted to be void in toto appears from the language of the proviso limiting the time within which remedy given by the statute shall be availed of.

It would seem that the remedy is limited to "the

correction of such error or errors," that is, errors arising out of a miscalculation or a misinterpretation of the law, or some other mistake of like nature.

Even though it should be determined that this statute plainly covers the case at bar, we still submit it does not measure up to the requirements of an adequate remedy at law for the reason that the Treasurer is not required to refund the tax unconditionally, but only when there are funds in the Treasury not otherwise appropriated.

So that a taxpayer pursuing this remedy can have his demand for repayment fully met by the statement of the Treasurer that there are no unappropriated funds, and it can be said without the slightest disrespect or disloyalty that such condition is apt to prevail with respect to the Treasury of the State of North Carolina in the light of the rapid progress that is being made by this State in various public improvements.

An argument is not needed to establish that promised action by the Attorney General, however sincere and reasonably sure of fulfillment, is not a "legal remedy."

But, aside from the foregoing, the plaintiff is entitled to its remedy in equity, because under the Statutes of North Carolina, income tax is a lien upon all of the property of the taxpayer and it, therefore, casts a cloud upon the title of the property that is not assessed or involved, and this fact alone gives a court of equity jurisdiction.

Shaffer v. Carter, 252 U. S. 48.

The foregoing contention is not foreclosed by the decision of this Court in *Keokuk & Hamilton Bridge Company v. Salm, et al.*, 258 U. S. 122, for many reasons. In that case the Court pointed out that the payment of the tax was *not* by distraint or levy, but by legal proceedings. The contrary is true here. In that case the Court had under consideration an invalidity which consisted wholly of a claim of discriminatory overvaluation. In this case we have a claim of unconstitutionality on several grounds and a claim of a cloud cast upon the title. In this case we have also the general policy of the State to permit an injunction in the matter of invalid taxes. Such policy was wholly absent in the Bridge case.

The contention that Appellant may pay and sue to recover is not an adequate remedy at law.

King v. Northern Pacific, 196 Fed. 323, 325.

Where a person is entitled to litigate in a Federal Court, it is not an adequate remedy at law to be invited into a State Court by his antagonist to adjudicate his rights.

U. S. Life Ins. Co. v. Cable, 98 Fed. 761, 763.

A State cannot tie up a citizen of another State, for property rights within its territory invaded by unauthorized acts of its own officers, to suits for redress in its own courts.

Smyth v. Ames, 169 U. S. 466, 517.

The North Carolina Income Tax Law is Void under the Commerce Clause of the Federal Constitution.

A State income tax law levied in part upon *gross* income or earnings from interstate commerce is a direct burden upon interstate commerce contrary to the Commerce Clause of the Federal Constitution.

Galveston, etc., Ry. v. Texas, 210 U. S. 217, 227;

U. S. Glue Co. v. Oak Creek, 247 U. S. 321;

Shaffer v. Carter, 252 U. S. 37, 57;

Underwood Typewriter Co. v. Chamberlain, 254 U. S. 113, 120;

Crew Levick Co. v. Pennsylvania, 245 U. S. 292, 297.

The North Carolina law taxes in part the *gross* income from interstate commerce of Appellant in that it does not permit the deduction from gross of the accounts denominated by the Interstate Commerce Commission Classification as follows:

"No. 537—Rent for Locomotives."

"No. 538—Rent for Passenger Train Cars."

"No. 541—Joint Facility Rents."

"No. 542—Rent for Leased Roads."

"No. 547—Interest on Unfunded Debt."

"No. 621—Miscellaneous Debits" (bad debts written off during year in North Carolina).

A State income tax law is unconstitutional and violates the Fourteenth Amendment to the Constitution of the United States if the classification provided therein is unreasonable, arbitrary, discriminatory, and without reasonable basis.

Royster Guano Co. v. Virginia, 253 U. S. 412, 415;

Gulf, Colorado & Santa Fe v. Ellis, 165 U. S. 150, 156;

Underwood Typewriter Co. v. Chamberlain, 254 U. S. 113, 121;

Shaffer v. Carter, 252 U. S. 37, 58.

The classification in the North Carolina Income Tax Law renders it invalid under the above decisions in that—

Under Section 306 individuals and other corporations are permitted to deduct from gross income in arriving at the “net income” to be taxed:

(a) “2. Rentals or other payments required to be made as a condition of the continued use or possession, for the purposes of the trade or property to which the taxpayer has not taken or is not taking title or in which he has no equity.”

and Appellant and other railroads which keep their accounts according to the Standard Classification of Accounts prescribed by the Interstate Commerce Commission are not allowed similar deductions.

(b) “3. All interest paid during the income year on indebtedness except interest on ob-

ligations contracted for the purchase of non-taxable securities. Dividends on preferred stock shall not be deducted as interest."

and Appellant is not allowed to make a like deduction.

(c) "7. Debts ascertained to be worthless and charged off within the income year if the amount has previously been included in gross income in a return under this act."

Appellant is not allowed a like deduction. It is allowed to deduct the item "Uncollectible Revenue," but that as per Standard Classification of Accounts does not include bad debts written off during the year accrued in North Carolina.

The Income Tax is Unconstitutional in That It Violates the Uniformity Section of the North Carolina Constitution.

The following cases hold that the Uniformity Section applies to this kind of tax, as well as to ad valorem taxation.

State v. Williams, 158 N. C. 610, 613;
Gatlin v. Tarboro, 78 N. C. 119, 121;
Land Co. v. Smith, 151 N. C. 70, 75.

And in the particulars set out under above item of this brief the classification is arbitrary and unreasonable.

A State's Statutory Definition of What Constitutes "Net Income" of an Interstate Railroad Whose Gross is Derived in Large Part from Interstate Commerce Cannot Legally Include as a Part of Such Net Income Any Item Prescribed by the Interstate Commerce Commission's Classification of Accounts to be Deducted from Gross Income before Arriving at Net Income.

ARGUMENT.

To a large extent the difference between counsel in this cause does not lie in any statement of the well established principles of law as set forth in the decisions of this Court, but is in the application of those principles to the facts of this case.

This Court has repeatedly announced that in determining whether a State tax violates the Federal Constitution, it will be governed by its judgment of the actual operation and effect of the law in each case.

Crew Levick v. Pennsylvania, 245 U. S. 292, 294;

American Manufacturing Co. v. St. Louis, 250 U. S. 459, 463;

Shaffer v. Carter, 252 U. S. 37, 55.

It must be admitted that the State has not the power to tax gross income from interstate commerce, such tax being void as a direct burden thereon, as distinguished from a remote and incidental burden.

The North Carolina Constitution correctly limits the income tax to net income and the legislative act in words taxes net income, but we contend that the Legislature cannot by its fiat, make that net income which is not in fact net, but is composed in

part of gross income. If this is not true, a State may by the device of definition nullify the protection given gross revenue from interstate commerce by the Commerce Clause of the Constitution.

What Is Net Income?

This Court, in the case of *DeGanay v. Lederer*, wherein was involved the validity of the Income Tax Act of Congress as applied to income from securities of a citizen of France, held by a domestic company on property owned in the United States, in passing upon the meaning of the term "property," restated the general rule of interpretation:

"Unless the contrary appears, statutory words are presumed to be used in their ordinary and usual sense, and with the meaning commonly attributable to them."

DeGanay v. Lederer, 250 U. S. 376, 381.

The term "net income" in its usual and ordinary sense means that income which is left after deducting from gross earnings the expense of producing such earnings. It means what is left, if anything, after you have squared accounts, the outgo vs. the intake, not including capital charges. If that is a correct definition, the question is narrowed to what items of expense may properly be considered as incurred in producing the gross earnings.

Appellant says, for illustration, that if it pays out money for the rent of a locomotive or a passenger car (52) that such rental payments are a natural ordinary expense to be deducted from the

earnings produced by those locomotives and cars before you arrive at the net. This common sense proposition is backed up by the Standard Classification of Accounts of the Interstate Commerce Commission, which permits such deductions. The State recognized the principle when it permitted by amendment to the law the deduction of "car hire." That account under the standard classification prescribed to be followed by the State, includes freight cars only. Why deduct rental of freight cars and refuse to deduct rental of passenger cars?

The term "net income" has been defined in a general way by this Court. In the case of *Union Pacific v. U. S.*, the Court had to determine what constituted net earnings under an Act of Congress which obligated the Railway to pay the Government up to a certain period five per cent of the net earnings. The Court said:

"Having considered the question of receipts or earnings, the next thing in order is the expenditures which are properly chargeable against the gross earnings in order to arrive at the 'net earnings,' as this expression is to be understood within the meaning of the act. As a general proposition, net earnings are the excess of the gross earnings over the expenditures defrayed in producing them, aside from, and exclusive of, the expenditure of capital laid out in constructing and equipping the works themselves. It may often be difficult to draw a precise line between expenditures for

construction, and the ordinary expenses incident to operating and maintaining the road and works of a railroad company. Theoretically, the expenses chargeable to earnings include the general expenses of keeping up the organization of the company, and all expenses incurred in operating the works and keeping them in good condition and repair; whilst expenses chargeable to capital include those which are incurred in the original construction of the works and in the subsequent enlargement and improvement thereof."

Union Pacific v. United States, 99 U. S. 402, 420.

It is proper, however, to call attention to the fact that the Court in that case excluded from "net earnings," as contemplated by the Act of Congress, interest on bonded debt of the company, saying that that item should be charged to capital interest account and not to current expenditures.

This Court, in the case of *Peck v. Lowe*, 247 U. S. 165, had before it the question of the validity of a tax upon the entire net income, the controversy being over so much of the tax as was attributable to the income from shipping to foreign countries. The Court, through Mr. Justice Van Deventer, held that there was no discrimination and that the objection against the tax was not well grounded, and said:

"The tax is levied after exportation is completed, after all expenses are paid and losses

adjusted, and after the recipient of the income is free to use it as he chooses."

Applying that definition of net income to this case it is found that all expenses have not been paid and "losses adjusted." The record shows that item "No. 621—Miscellaneous Debits" is not permitted to be deducted and that the item contained (15) bad debts written off during the year accrued in North Carolina in the sum of \$26,196.97 (62). Until that deduction is made, all losses have not been adjusted and the net has not been reached, and the Appellant is not free to use it as he chooses until the expense of earning it, including the above loss, has been paid.

The Lowe case was followed in the case of *U. S. Glue Co. v. Oak Creek*, which called attention to the fact that the tax was on only net receipts after all expenses were paid and losses adjusted and the recipient of the income was free to use it as he chose, and said:

"A tax upon the net profits has not the same deterrent effect, since it does not arise at all unless a gain is shown over and above expenses and losses, and the tax cannot be heavy unless the profits are large."

U. S. Glue Co. v. Oak Creek, 247 U. S. 321, 329.

What items of deduction from gross to arrive at true net has the State failed to allow? The

answer to this question will have to come from the record. As set forth in the statement of facts, the State deducts from gross revenue the following items:

(1) Proportionate average of operating expenses, as shown by the Interstate Commerce Commission Standard Classification of Accounts.

(2) Uncollectible revenue.

(3) Taxes paid in North Carolina for the income year other than income taxes and war profits and excess profits taxes.

(4) An equal mileage proportion of "car hire."

Attention is again directed to the fact that the North Carolina Law permits deduction of "car hire," while the Interstate Commerce Commission's Classification, under the general head of "Equipment Rents," permits deduction not only of car hire, but items 536 to 540, as set out on record, page 58, being:

Account No. 537.	Rent for Locomotives.
" " 538.	Rent for Passenger Cars.
" " 539.	Rent for Floating Equipment.
" " 540.	Rent for Work Equipment.

which would mean that instead of, as shown on Exhibit "A" (14), deducting for account of car

hire the debit balance of \$589,386.05, there should have been deducted the sum of \$596,348.84 (15).

The State does not permit any deduction of the following items:

“541. Joint Facility Rents, \$213,767.07.” (15)

These rents are the cost of trackage in North Carolina and the payment for use of certain terminals in North Carolina (53). If this deduction of joint facility rents is made there should be included on the income side revenue which came to the Railway under Account No.:

“508. Joint Facility Rent Income, \$66,886.47.”

The State does not permit any deduction of item—

“542. Rent for Leased Roads, \$591,491.75.” (15)

The record, at pages 59 to 61, shows that the rents sought to be deducted are for the rental of roads or parts of roads in North Carolina and the earnings which are taxed are derived in part from said roads. It is stated that said rent for leased roads does not escape taxation because the roads to which this rental is paid were assessed and paid to North Carolina an income tax based on this rental received. It is further pointed out that the question of whether or not any rental should be de-

ducted is determined in the law itself in Section 306, paragraph 2, which prescribes the deductions allowed individuals and private corporations, and which reads as follows:

"2. Rentals or other payments required to be made as a condition of the continued use or possession, for the purposes of the trade of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

The State does not allow as a deduction interest on unfunded debt, which is allowed by the Interstate Commerce Commission's Classification under item—

"547. Interest on Unfunded Debt, \$116,-151.96."

Arguments may be advanced for the classification of railroads different from an individual and not allowing deduction of interest on funded debt, which for this company amounted to \$1,481,-391.58. (15)

Such arguments we believe to be wholly unsound, but at least there is no such difference or distinction between interest on borrowed money of an individual, which is permitted as a deduction, and interest on the unfunded debt of a railroad.

Is the Classification Arbitrary?

The power of the State to classify is undoubted so long as the classification is not unreasonable and

is founded on some fair and substantial ground of difference.

Royster Guano Co. v. Virginia, 253 U. S. 412, 415.

We respectfully submit that while entirely legal to put all railroads in a class separate from individuals and corporations generally, it is invalid classification to permit individuals and corporations to make the following deductions, among others, and not permit like deductions to railroads, viz.:

(1) Under Section 306, paragraph 2, individuals are allowed to deduct:

“Rentals or other payments required to be made as a condition of the continued use or possession, for the purposes of the trade, of property to which the taxpayer has not taken or is not taking the title or in which he has no equity.”

Appellant contends there is no reasonable basis for allowing such rental deduction to individuals and corporations generally and denying to it the deduction of Joint Facility Rents, amounting to \$213,767.07. Attention is directed that this account for trackage rights, joint depots in North Carolina, etc., is separate and distinct from “Rent of Leased Roads.”

(2) Section 306, paragraph 3, allows other corporations a deduction of interest paid during year on indebtedness, while such deduction is denied

Appellant. The record shows (62) there are two accounts under Interstate Commerce Commission's Classification:

546. Interest on Funded Debt.

547. Interest on Unfunded Debt.

and that Appellant paid in the year \$1,481,391.58 interest on funded debt and \$116,151.96 interest on unfunded debt, neither of which deductions are allowed. The showing is (85) that there are many industrial corporations doing business in North Carolina taxed under this law which have very large mortgage debts and are allowed deduction of interest thereon, for example:

American Agricultural Chemical Company:

Common stock.....	\$33,322,126
Preferred stock.....	28,455,200
First mortgage bonds.....	6,252,000
1st ref. mortgage s. f. gold bonds, Series "A"	30,000,000

American Sugar Refining Company:

Common stock.....	45,000,000
Preferred stock.....	45,000,000
15-year gold bonds.....	30,000,000

American Tobacco Company:

Common stock "A".....	40,242,400
Common stock "B".....	49,344,200
Preferred stock.....	52,699,700
Gold bonds.....	371,950
Gold bonds and cons. Tobacco Collateral Trust Mortgage Bonds.....	1,365,300
Series of gold notes.....	10,000,000
8 per cent dividend certificates.....	8,058,834

Du Pont, I. E., de Nemours & Company:

Common stock.....	63,378,300
Debenture stock.....	71,243,250
10-year gold bonds.....	35,000,000

Galena Signal Oil Company:	
Common stock.....	16,000,000
Preferred stock.....	2,000,000
New preferred stock.....	4,000,000
Convertible debenture.....	6,000,000
Entire stock of subsidiary companies.....	2,800,000
Galena Signal Oil of Texas bonds.....	2,800,000
General Electric Company:	
Common stock.....	176,329,100
Debenture for Sprague Stock.....	2,047,000
Debenture	15,136,500
Debenture bonds.....	15,000,000
Kelly Springfield Tire Company:	
Common stock	9,096,002
Preferred stock.....	3,137,100
Second preferred.....	5,625,200
10-year s. f. gold notes.....	10,000,000
Morris Company:	
1st mortgage	17,626,000
10-year s. f. gold notes.....	15,000,000
Wm. F. Mosser Co. 10-year s. f. notes..	3,000,000
Swift & Company:	
Common stock.....	150,000,000
1st mortgage s. f. gold bonds.....	28,923,500
Gold notes.....	65,000,000
Texas Company:	
Stock	164,450,000
3-year s. f. notes.....	22,772,000

If there be anything in the claim that such mortgage bond interest is more properly a capital charge, which we earnestly deny, we fail to see why there is any fair ground of difference between interest on such bonded indebtedness of other corporations and like bonded indebtedness of Appellant.

(3) Under Section 306, paragraphs 6 and 7, individuals and corporations generally are permitted to deduct losses sustained during the year and debts ascertained to be worthless and charged off.

The record shows that Appellant and other railroads are allowed to deduct "uncollectible revenue" as per Standard Classification of Accounts of the Interstate Commerce Commission. This appears on the form sent to Appellant by the Commissioner of Revenue and on the form is a note that the accounts stated in the form are according to the Standard Classification of Accounts. Uncollectible revenue is transportation receipts, such as freight not paid.

The Interstate Commerce Commission has another classification (621. Miscellaneous Debits) to which account is charged bad debts written off, other than purely transportation receipts, and on page 15 of the Record it is shown that Appellant had in the year \$26,196.97 of such debts in North Carolina (62). We can find no reasonable basis for the difference in treatment in this respect.

The State Should, in Taxing Net Income of an Interstate Carrier Derived from Interstate Transportation, Allow the Deductions permitted by the Interstate Commerce Commission in its Standard Classification of Accounts.

In the case of *Kansas City Southern v. United States*, 231 U. S. 423, there was involved a claim of invalidity of the regulations of the Interstate Commerce Commission relative to the method of keeping accounts of interstate carriers. The Court quoted from and referred to the *Union Pacific Case*, in the 99th U. S., and the case of *I. C. v. Interstate Commerce Commission*, 206 U. S. 441, and said:

"In both cases it was recognized that in so complicated a matter as the construction, maintenance, and operation of a railroad line, it is difficult to define and perhaps more difficult to consistently apply a precise distinction between capital and expense accounts; and while the propriety of distributing improvement costs over a series of years was recognized, the impossibility of scientific accuracy in that regard was acknowledged. The question now is, whether the regulations of the Commission under attack do violence to these general principles—rather, it is whether those regulations are so clearly contrary to these and other applicable principles that they should be set aside as being in excess of the powers conferred by Congress upon the Commission."

Kansas City Southern v. United States, 231 U. S. 423, 447.

Accordingly it upheld the regulations of the Commission. The Court also said:

"So far as the profits of past operations have not been distributed to the stockholders, they are represented in the profit and loss account, and therefore such an abandonment or depreciation is properly chargeable to that account unless a special depreciation account has been established in anticipation of such abandonments; and for such an account, provision is made in the regulations."

In the case of *I. C. C. v. Goodrich Transit Co.*,

224 U. S. 194, the Court, in dealing with the meaning of Section 20 of the Interstate Commerce Act, which is the Section that empowers the Commission to require the interstate carriers to keep a uniform system of accounts, said at page 215:

"In Section 20 Congress has authorized the Commission to require annual reports. The act itself prescribes in detail what those reports shall contain. The Commission is permitted, in its discretion, to require a uniform system of accounting, and to prohibit other methods of accounting than those which the Commission may prescribe. In other words, Congress has laid down general rules for the guidance of the Commission, leaving to it merely the carrying out of details in the exercise of the power so conferred. This, we think, is not a delegation of legislative authority."

Again, at page 216:

"Bookkeeping, it is said, is not interstate commerce. True, it is not. But bookkeeping may and ought to show how a business which, in part at least, is interstate commerce, is carried on, in order that the Commission, charged with the duty of making reasonable rates and prohibiting unfair and unreasonable ones, may know the nature and extent of the business of the corporation, the cost of its interstate transactions and otherwise to inform itself so as to enable it to properly regulate the matters which are within its authority."

It further held, at page 211:

“We think this section contains ample authority for the Commission to require a system of accounting as provided in its orders and a report in the form shown to have been required by the order of the Commission.”

Again, this Court in the case of *Kansas City Southern v. United States*, 231 U. S. 423, upheld the power of the Commission to prescribe the method of accounting of an interstate railroad, and on page 442 said:

“Congress, in authorizing the Commission to prescribe a uniform system of accounts, recognized that accounting systems were not then uniform; and in reiterating this authorization in 1906, and adding a prohibition against the keeping of other accounts than those prescribed, manifested a purpose to standardize and render uniform the accounts of the different carriers with respect to matters that entered into property and the improvements thereof, on the one hand, and the current operations of the company, on the other. By the very terms of Section 20, Congress at least outlined the classification of the carriers’ accounts, for it required the annual reports to show ‘the amount of capital stock issued, the amounts paid therefor, and the manner of payment for the same . . . the surplus fund, if any, . . . the funded and floating debts, . . . the cost and value of the carrier’s property, franchises and equipments; . . . the amounts expended for

improvements each year, how expended, and the character of such improvements; the earnings and receipts from each branch of business and from all sources; the operating and other expenses; the balances of profit and loss; and a complete exhibit of the financial operations of the carrier each year including an annual balance sheet.' "

The foregoing decisions show that in certain cases the classification of the Commission has been under fire and been sustained and that the Court upheld the power of the Commission to prescribe the method of accounting.

We go one step further: The Transportation Act, in enlarging the powers of the Commission and in providing what net railway operating income would be considered a fair return upon the value of the Railway, defined that term in Section 15(a) as follows:

" * * * and the term 'net railway operating income' means railway operating income, including in the computation thereof debits and credits arising from equipment rents and joint facility rents."

It will be noted that Congress has said that net railway operating income should include joint facility rents as a debit or a credit as the case might be. We contend that "net railway operating income" is a term used before arriving at "net income" and that there are many credits and debits to be accounted for before net income is arrived at

but at least it shows that Congress determined that in considering net operating income, joint facility rents should be included. The Income Tax Act of North Carolina, as has been previously shown, does not include such equipment rents or joint facility rents. The State, in the Income Tax Act, in a measure recognized the Standard Classification of Accounts of the Interstate Commerce Commission. The trouble is that it did not follow throughout that classification, with the result that the tax in part rests upon gross income from interstate commerce, which the State may not constitutionally tax.

The case comes down to this: The State contends that it is within the power of the Legislature to define "net income." We deny this, in so far as concerns the State's power to define net income when derived from interstate commerce if the State's definition leaves in as net any part of the gross. If the State had the power to tax the gross income from interstate commerce the State, subject to uniformity, would be allowed to define by legislative act what deductions may be made in arriving at the "net" to be taxed, for the reason that it is by legislative favor that the State excludes any part from taxation; but when taxing income from interstate commerce it is by favor of the Constitution of the United States, as interpreted by this Court, that the State may tax any part of interstate revenue, and, therefore, it is entirely reasonable to say that the Interstate Commerce Commission, the governmental agency, should say what shall

constitute the deductions before the "net" is reached which the State may tax. Hence we say that the Interstate Commerce Commission's Classification should not be departed from. If the State of North Carolina can exclude from the deductions from gross, and thereby include in the sum to be taxed as net, any one item which should properly, under the Interstate Commerce Commission's Classification, be deducted from gross or which should be deducted in any proper accounting before arriving at net income, then the State has violated the Commerce Clause of the Federal Constitution and the Uniformity Clause of the State Constitution, and what it has done differs in degree only from a case where it would tax all of the gross. It is true the State has denominated the sum it taxes as net, but that cannot be the sole guide. If one State has the right then the other thirteen States through which Appellant runs have an equal right and the practical result would be that a material part of the gross income from interstate transportation would be taxed.

The North Carolina Income Tax Act, in Article I, provides in part:

"Except as otherwise provided in this act the purpose is to conform to the definitions of income in the revenue laws of the United States Government and regulations made under its authority, in so far as they apply."

The Federal Income Tax Act permits all of the deductions herein claimed before the "net income"

taxed thereunder is arrived at. It is submitted that since Congress has provided a standard, which follows the Interstate Commerce Commission Classification of Accounts, for the sake of uniformity, in so far as revenue from interstate commerce is concerned, the several States should follow that plan. Income Tax Acts are being enacted by many of the States, and for each of the thirteen through which Appellant operates to have a different method would lead to confusion and unfairness.

There is set forth on pages 73 to 81 of the record a statement of the "General Accounts" and "Primary Accounts" prescribed by the Commission for "Operating Revenue" and "Operating Expenses," also a statement (79) of the "Income Accounts" credit and debit. There is attached hereto, marked Exhibits A and B, the form in which the Commission prescribes that the accounts be rendered. These forms merely put in statement form what is shown on record pages 73 to 81. To save expense, these forms (62) (Exhibit 3 to E. H. Kemper's testimony) were not copied in the record because the record pages 73 to 81 already contained the facts.

If Exhibit A is referred to and compared with the form (14) prescribed by the Income Tax Law, it will be seen that the State calls net income that which the Interstate Commerce Commission denominates "Railway Operating Income," with the exception that the State does not allow the deduction of equipment rents and joint facility rents.

The State has not considered at all the income statement, as prescribed by the Interstate Commerce Commission, as set forth on Exhibit B. As construed by the Interstate Commerce Commission, the whole story is not told when we arrive at railway operating income, and therefore it provides that there shall be added certain non-operating income which gives a "total gross income." From this they make "deductions from gross income" with the final result of a figure which is called "net income."

It is submitted that when seeking to ascertain the net income, there must be deducted all of the expense of earning such income and that such deductions should not be confined to the actual or purely "operating expenses" as that term is usually understood but should include all expense necessarily incident to the conduct of the business and the bringing in of the revenue, other than capital expenditure. We therefore say that the State stopped short of net income, and the law is unconstitutional.

Respectfully submitted,

S. R. PRINCE,
W. M. HENDREN,
Counsel for Appellant.

L. E. JEFFRIES,
Of Counsel.

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COMPARATIVE REPORT OF REVENUES AND EXPENSES

Months of _____ 192__ and 192__ and _____ Months Ended _____ 192__ and 192__

	MONTH THIS YEAR	MONTH LAST YEAR	INCREASE OR DECREASE	PER CENT.	PERIOD THIS YEAR	PERIOD LAST YEAR	INCREASE OR DECREASE	PER CENT.
MILES OF ROAD OPERATED	_____ MILES	_____ MILES	_____ MILES		_____ MILES	_____ MILES	_____ MILES	
OPERATING REVENUES								
Freight								
Passenger								
Mail								
Express								
All other Transportation								
Incidental								
Joint facility—Cr.								
Joint facility—Dr.								
RAILWAY OPERATING REVENUES								
OPERATING EXPENSES:								
Maintenance of Way and Structures								
Maintenance of Equipment								
Traffic								
Transportation								
Miscellaneous Operations								
General								
Transportation for Investment—Cr.								
RAILWAY OPERATING EXPENSES								
NET REVENUE FROM RAILWAY OPERATIONS								
Ratio of Operating Expenses to Operating Revenues								
Ratio of Transportation Expenses to Operating Revenues								
Railway Tax Accruals								
Uncollectible Railway Revenues								
TOTAL EXPENSES, TAXES AND U. R. REVENUES								
Ratio to Operating Revenues								
RAILWAY OPERATING INCOME								

APPROXIMATE INCOME STATEMENT

Month of 192 and 19 and Months Ended 192 and 19

LIST OF ACCOUNTS	MONTH THIS YEAR	MONTH LAST YEAR	INCREASE OR DECREASE	PERIOD THIS YEAR	PERIOD LAST YEAR	INCREASE OR DECREASE
TOTAL OPERATING INCOME						
NON-OPERATING INCOME:						
Income from Lease of Road						
Miscellaneous Rent Income						
Miscellaneous Non-operating Physical Property						
Separately Operated Properties—Profit						
Dividend Income						
Income from Funded Securities						
Income from Unfunded Securities and Accounts						
Income from Sinking and Other Reserve Funds						
Release of Premiums on Funded Debt						
Contributions from Other Companies						
Miscellaneous Income						
TOTAL NON-OPERATING INCOME						
TOTAL GROSS INCOME						
DEDUCTIONS FROM GROSS INCOME:						
Rent for Leased Roads						
Miscellaneous Rents						
Miscellaneous Tax Accruals						
Separately Operated Properties—Loss						
Interest on Funded Debt						
Interest on Equipment Obligations						
Interest on Unfunded Debt						
Amortization of Discount on Funded Debt						
Maintenance of Investment Organization						
Income Transferred to Other Companies						
Miscellaneous Income Charges						
Dividend on Southern Ry.—M. & O. Stock Trust Cfs						
TOTAL DEDUCTIONS						
NET INCOME						
DISPOSITION OF NET INCOME:						
Income applied to Sinking and Other Reserve Funds						
Dividend Appropriations of Income						
Income Appropriated for Additions and Betterments						



No. 756

THE SOUTHERN RAILWAY COMPANY, *Appellant,*
vs.

A. D. WATTS,
Commissioner of Revenue for North Carolina

No. 724

ATLANTIC COAST LINE RAILROAD COMPANY, *Appellant,*
vs.

A. D. WATTS,
Commissioner of Revenue for North Carolina

No. 727

NORFOLK SOUTHERN RAILROAD COMPANY, *Appellant,*
vs.

A. D. WATTS,
Commissioner of Revenue for North Carolina

No. 744

SEABORD AIRLINE RAILROAD COMPANY, *Appellant,*
vs.

A. D. WATTS,
Commissioner of Revenue for North Carolina

**ARGUMENT OF GEO. H. BROWN
FOR DEFENDANT APPELLEE**

GEORGE H. BROWN,
of Counsel for Defendants.

These suits in Equity were brought to enjoin the collection of an income tax imposed under Constitution of North Carolina by the Legislature upon the net incomes of Plaintiffs for year 1921. There was no interlocutory injunction. The cases were heard upon final hearing by Connor, District Judge in Eastern District of North Carolina. The Court rendered judgment for Defendant, dismissing the bills and Plaintiffs appealed.

The Defendant earnestly contends that the suits cannot be maintained under the well settled principle that equity will not interfere where the Plaintiff has an adequate remedy at law.

The income tax Statutes, Public Laws of 1921, Sect. 701, etc., (all fully cited in defendants' brief), gives an adequate remedy to any person or Corporation complaining of unlawful or erroneous assessment of income tax by appeal from Tax Commission to Superior Court, thence to State Supreme Court. The judgment of the latter Court can be reviewed on writ of error by this Court. To give full effect to this very full remedy at Special Session, 1921, the Legislature provided for prompt repayment of such tax adjudged to be improperly collected.

I ask the Court to examine carefully the part of defendants' brief where the Statutes and decided cases of this Court are cited and quoted from.

The sums involved are not so large that the State can possibly have difficulty in promptly refunding them. Consequently there cannot be any irreparable damage inflicted by remitting plaintiffs to their remedy at law.

In addition to well settled principles of equity announced in numerous decisions of this Court, Section

267 of Judicial Code of U. S. says:

"Suits in equity shall not be sustained in any Court of the United States in any case where a plain, adequate and complete remedy may be had at law."

The remedy provided by the Statutes of North Carolina is plain, adequate and complete. It could not be more so. We think this principle of equity set forth in the Judicial Code should be certainly enforced in cases affecting State taxation. The Statute applies not alone to Railroad Corporations, but to all Corporations and individuals.

The plaintiffs set up seven objections to the validity of this tax, all of which are set out and considered in defendants' brief. I will discuss only a few.

It is contended that this tax is levied upon the gross income of plaintiffs and not on net income and that it constitutes a direct burden on Interstate Commerce in violation of the Federal Constitution.

I will ask Your Honors to bear in mind the principle set out in very many decisions of this Court that an Act of a State Legislature will not be declared void unless its violation of the Federal Constitution is clear, complete and unmistakable, and, (as said in *Railroad Co. vs. Powers*, 201 U. S., 245), "especially is this true when the Statute is one affecting the revenues of the State and therefore of public interest."

It is well settled by decisions of this Court, cited in our brief, that an income tax may be levied by a State on net incomes of Corporations engaged in interstate commerce earned within the State, and that such tax is not

a burden on interstate commerce although the net incomes taxed may be derived in part or mainly from interstate business.

I call Your Honors' attention to two recent cases:

Glue Co. *vs.* Oak Creek, 247 U. S., 31.

Underwood Co. *vs.* Chamberlain, 254 U. S., 113—
cited in our brief.

We earnestly insist that the Statute upon its face purports to tax only the net income of plaintiffs on business done in North Carolina and that if the computation is made as directed therein only such net income is taxed. Section 202 reads:

"The basis of ascertaining the net income of (the plaintiffs) . . . shall be . . . their net income within this State shall be ascertained by taking their gross 'operating revenues' within the State, including . . . the equal mileage proportion within this State of their interstate business and deducting from their gross 'operating revenues' (so ascertained) the proportionate average of 'operating expenses,' or 'operating ratio,' for their whole business, as shown by the Interstate Commerce Commission Standard Classification of Accounts."

A mathematical calculation made according to the Statute gives a result which is denominated therein the net operating income of the Railroad Company.

It is seen that under this Statute all of the operating expenses allowed by the Interstate Commerce Commission are to be deducted from the gross revenues. Then

the Statute authorizes other specific deductions from the net operating income in order to produce the taxable net income. The language of the Statute is plain:

"From the net operating income thus ascertained shall be deducted 'uncollectible revenue' (in other words, losses or bad debts) and taxes paid in this State for the income year, other than income taxes and war profits and excess-profits taxes, and *the balance* shall be deemed to be their net income taxable under this act."

The plaintiffs have filed as exhibits the regulations of the Commerce Commission as to Standard Classification of Accounts. Reference to these will show the completeness of detail with which every conceivable operating expense is allowed. All of these items are allowed plaintiffs as deductions by the North Carolina Statute. Many expenses are included not allowed under the income tax law of North Carolina to other classes of tax payers, either individuals or Corporations, such as purchase of tools and small equipment which are allowed as expenses to Railroads under this classification, but which are considered as invested capital in case of other taxpayers. The very large item of money paid by Railroads in satisfaction of judgments for tools is allowed as deductions. This item is not allowed under North Carolina Statute to other taxpayers. All amounts paid out as insurance premiums for all kinds of insurance, storm casualty, fire, etc., are allowed as deductions to those Public Service Corporations keeping the standard classification of accounts and not allowed other taxpayers.

A general summary of these various and very numer-

ous items allowed on deductions to Railroads is attached to answers in these cases as Exhibit A.

It seems to me that an examination of the State income Statute, taken in connection with the standard classification of accounts and the specific deductions allowed in addition by the Statute, will disclose plainly that the net income only of plaintiffs is subjected to taxation and that that is all that has been taxed.

It is contended that there is an illegal and unjust discrimination made against plaintiffs and in favor of individuals and other smaller Corporations doing manufacturing and other kinds of business.

It is claimed that this discrimination consists in failure to allow plaintiffs deduction from their gross income of rental money paid out for leased lines of Railroads. Also in failure to allow deduction for interest paid out on their bonded indebtedness.

This brings me to consider the question of classification for purposes of taxation.

The Railroads in North Carolina have been put for purposes of taxation in one class and it must be admitted that as between those Corporations, whether foreign or local, there is no discrimination. They are all treated alike and fed out of the same spoon.

I contend that the classification complained of is upon a practicable and reasonable basis and is no such arbitrary and unjust discrimination as is prohibited by the Fourteenth Amendment or the uniformity clause of the State Constitution.

The Fourteenth Amendment prescribes no rigid rule of equality, but leaves to the sound discretion of the States of the Union a wide latitude in classifying all

kinds of business and occupations whether conducted by individuals or Corporations, foreign or domestic, for the purpose of government. If such classification is practical and not confiscatory or manifestly arbitrary, it is valid and will not be reviewed or disturbed by this Court.

Railroad Company *vs.* Pennsylvania, 134 U. S., 232, and other cases cited in defendants' brief.

This principle is always applied very liberally by this Court when the classification is made by the State in the exercise of its powers of taxation. This Court is always very loth to interfere with the workings of the State Government in its attempts to raise revenue for its support.

Connolly *vs.* Sewer Co., 184 U. S., 540, and other cases in defendants' brief.

In this case it is said: "A tax may be imposed only upon certain callings and trades, for when the State exerts its power to tax, it is not bound to tax all pursuits or all property that may be legitimately taxed for governmental purposes. It would be an intolerable burden if a State could not tax any property or calling unless, at some time it taxed all property or all callings. Its discretion in such matters is very great and should be exercised solely with reference to the general welfare as involved in the necessity of taxation for the support of the State. A State may *in its wisdom* classify property for purposes of taxation and the exercise of its discretion is not to be questioned in a Court of the United States so long as the classification does not invade rights secured by the Constitution of the United States."

It is the uniform consensus of all the utterances of this Court on the subject that any classification is per-

missible which has a reasonable relation to some permitted end of governmental action. It is sufficient if the classification is reasonably founded in the purposes and policy of taxation.

This principle is clearly stated by Justice Pitney in the *Royster guano* case, 253 U. S., 412, which is quoted from extensively in *Norfolk Southern* brief. That case says, "The latitude of discretion is notably wide for the purpose of taxation and the granting of partial or total exemptions upon the grounds of policy."

We maintain that the classification of all these great interstate railroads and other Corporations required to keep standard classification accounts in one class, is appropriate and reasonable, not arbitrary and rests upon substantial grounds of public policy in matters of taxation.

In this classification all Corporations similarly situated are treated exactly alike.

This is not a classification that is altogether illusory and made for the purpose of injuring and discriminating against those in the same class and similarly situated, in favor of other taxpayers.

The classification is founded in the very nature of the property classified. This Court has repeatedly recognized the fact that railroads differ so greatly from other property that it is necessary to classify and tax them differently from other property.

This Court has said that it is not only competent to make a separate class of all railroads, but it is competent for the Legislature to make classifications within the general class of railroads.

Savannah Railroad Company vs. Savannah, 198 U. S., 392.

In that case it was held competent for the Legislature to make a separate class for taxation of only those railroad Corporations using City Streets.

This subject of the right of a State to classify property for purposes of taxation is discussed in an interesting opinion by Mr. Justice McKenna, in *Hersler vs. Colliers Co.*, decided March 27, 1922, and the principles of law that are referred to are reasserted and approved. In that case this learned Justice says:

“And so classification has uses in government,—indeed, we may say, necessities in government,—for government as well as persons has purposes, varied and, at times exigent, and its legislation must be accommodated to them, either in convenience or necessity. That government has the power to do so we have often pronounced; not, however, omitting to recognize the restraints upon the power while expressing its range and adaptation. In its exercise in taxation, we have said, it is competent for a State to exempt certain kinds of property and tax others, the restraints upon it only being against ‘clear and hostile discriminations against particular persons and classes.’ Discriminations merely are not inhibited, for it was recognized that there are ‘discriminations which the best interests of society require.’ *Bell’s Gap R. Co. vs. Pennsylvania*, 134 U. S., 232.”

In the opinion in North Carolina Railroad tax cases of January 2, 1923, Justice Brandeis says: “Railroads differ in so many respects from other properties that they may, as a class, be taxed differently or additionally, if that is not inconsistent with the Constitution of the State.”

In the recent case of *Durham Service Co. vs. Durham U. S. Supreme Court*, reported March 15, 1923, p. 332, Mr. Justice McReynolds says: "The power of the Legislature to make reasonable classifications and to impose a different burden upon the several classes cannot be denied."

Another interesting opinion on the subject of State taxation is that of Mr. Justice Clark in *Duane vs. Jackson*, 256 U. S., 589. I commend those cases to Your Honors' consideration. They plainly declare, after reviewing the many decisions on the subject, that this Court will not interfere with the States in the matter of taxation and raising revenue unless the Legislation is manifestly confiscatory or destructive of some right guaranteed by the Federal Constitution. Certainly no case of that sort is presented in either of these records.

It is contended that there is an unconstitutional discrimination made against the Railroad Corporations because they are not allowed to deduct from their gross income the rental money paid out for railroad lines leased from other Railroad Corporations.

Also that Railroad Corporations are not permitted to deduct from their gross incomes the interest or their bonded indebtedness, while individuals and minor manufacturing Corporations are permitted to deduct interest on their debts.

Both these contentions I think are covered by the argument that the Legislature has the right to classify Railroad Corporations and put them in a class by themselves because they differ so materially from all other properties.

But I submit that this is not an illusory classification

but is founded in reason and common sense.

The Railroad Company most interested in the rental controversy is the Norfolk Southern. If there is any other, I am not aware of it.

The Norfolk Southern has leased from the State of North Carolina and some private stockholders the Atlantic & North Carolina Railroad for a period of 99 years, paying a stipulated rental and all taxes levied on the Corporation and leased property.

This is very different from the case of a private individual or an ordinary business corporation leasing pieces of property for short periods for use in their business.

That is not a capital expense but an expense incurred in operating a business already established. It is purely and simply an operating expense.

The Norfolk Southern desired to include the Atlantic road in its system. It did not have the cash to buy it out and out and it could not borrow it. So it leased the road for 99 years. This is really a capital expenditure, and is practically a purchase. It certainly is not an operating expense, I submit. It is the same as if it had taken the cash out of the Norfolk Southern treasury and paid for the leased road.

This Court has said that the net income of a Railroad Corporation is the excess of the gross earnings over the expenditures defrayed in producing them, aside from and exclusive of the expenditure of capital laid out in acquiring constructing and equipping the works themselves. *Union Pacific Railroad vs. United States*, 99 U. S., 402. See also *Cyc. 671, Railroad vs. United States*, 231 U. S., 445.

The principal item that all of plaintiffs contend should

be deducted in order to arrive at the taxable net income is interest on their bonded debt. There is no evidence that they have any floating debt.

Plaintiffs contend that failure to allow this is an illegal discrimination against them in favor of individuals and minor business corporations.

This Court has frequently said that it will not close its eyes to well known facts.

It is a part of the history of railroads in this country that they are almost always created and built by the proceeds of bond issues. They do have stock as all Corporations must have, but in the beginning of the enterprise it is very generally, if not always, of but small market value. After the organization of a railroad Corporation and the acquisition of the right of way, the first thing the promoters and incorporators do is to put a mortgage on the property after issuing the stock to themselves. These bond issues are widely advertised in financial centres and frequently sold at attractive prices.

The proceeds are used to build the railroad and to equip it, and these bonds are never paid, but always renewed or paid by another issue. This is the capital that creates the road. The interest on such debt is a capital expense and cannot be reasonably considered an operating expense.

Under the definition of net income as defined by this Court, it is gross income less only the expenses and losses incurred in earning that income. Expenditure incurred for capital, borrowed to create the road and its equipment is of a permanent character and should not be deducted in order to get at the net annual income.

In Black's Law Dictionary, citing 50 Georgia, 350, re-

ferring to net income and net profits it is said :

“This term does not mean what is made over the losses, expenses and interest on the amount invested. It includes the gain that accrues on the investment, after deducting simply the losses and expenses of the business.”

If the builders of a railroad had taken the cash out of their own pockets and put it in the construction of the road they could not charge up dividends as an operating expense. Not having the cash and having to borrow it, I see no reason that they should be allowed to charge up interest on borrowed capital as an operating expense.

The construction bonds of most railroads have very many years to run longer than any other kind of bonds. That is especially true of some of these plaintiffs. To allow them to charge up interest for all this long period as operating expenses would relieve of payment of all income taxes, or very nearly so.

I fail to see any authority cited by plaintiffs which requires that payments of interest on bonded indebtedness and rentals on 99 year leases of subsidiary roads must be deducted from gross income in order to produce that net income which is within the power of the State to tax.

The argument of plaintiffs that Interstate Commerce Commission has made these deductions is of no value. It was done solely for rate making purposes. This has no bearing, that I can see, upon the power of the Legislature, which alone is the question before this Court.

It is contended that the Income Statute of the State is in violation of the Constitution of the State, Art. 5, Sec.

3. This is the article containing the income tax amendment and is set out in full in the brief of the Norfolk Southern Railroad on page 31. I will not copy it again. It simply provides that laws shall be passed taxing by a uniform rule all moneys, credits, investments in bonds, stocks, etc., and all real and personal property according to its true value in money, etc.

In construing this provision of the Constitution before the Income Tax Amendment was added to it, the Supreme Court of North Carolina, in several decisions, decided that the Legislature of the State had power to classify occupations, and other subjects of taxation by statutory enactment and that such classification in Tax Statutes is not in contravention of the rule of uniformity prescribed in the State Constitution when the tax is imposed alike upon all of a class.

Albertson vs. Wallace, 81 N. C., 479.

Bickett vs. Tax Commission, 177 N. C., 433.

Cobb vs. Commissioners, 122 N. C., 307.

State vs. Roberson, 136 N. C., 587.

State vs. Hunt, 129 N. C., 686.

The foregoing ruling of the North Carolina Court was specifically approved by this Court in *Armour Packing*

Co. vs. Lacey, 200 U. S., 226.

This Court, prior to that case, has fully recognized and approved the ruling of State Courts that where the State Constitution, as in North Carolina requires that taxes shall be levied by uniform rule, it is perfectly competent for the State to tax corporations of different characters

in different ways. The uniformity rule only means that all of a class shall be treated alike.

State Railroad Tax Cases, 92 U. S., 575.

It is contended in brief of Norfolk Southern Railroad, p. 32, that there are several small railroads in North Carolina acting as common carriers who are not treated in same way as these plaintiffs. The character of these roads is described in the affidavits referred to on p. 32 of Norfolk Southern brief. They are logging roads, handling logs to the saw mills of the owners of the roads. Such roads nowadays are a necessary part of a saw mill outfit. For convenience sake some of them carry a very limited class of commodities, and this business is very small and done for the neighborhoods' convenience and does not pay the expenses incurred by it. The State Corporation Commission in its construction of the law does not treat them as in same class with the plaintiffs.

Whether for purposes of taxation these log roads come within Sect. 202 of income tax law and are to be taxed in same class as plaintiffs, has never been decided by the State Supreme Court.

These log roads claim they are not in same class and can not be so taxed. The point is not decided in *Stewart vs. Lumber Road*, 143 N. C., 47, cited in Norfolk Southern brief, p. 33, and I submit that case has but little, if any, bearing on this question. At time it was decided the income tax law had never been enacted. I submit that if these log roads have by misconstruction of the law escaped taxation for 1921, the first year our income tax law was in force, the tax can yet be collected. It is no reason why these plaintiffs should escape taxation. It

is not a discrimination within the 14th amendment. The N. C. income statute does not make any discrimination. It is simply, if wrong at all, an erroneous construction of the statute by the Corporation Commission. If plaintiffs are aggrieved they have their remedy, as under our law any tax payer can apply to the State authorities and State Courts to have property subjected to taxation which has inadvertently or intentionally escaped. If plaintiffs feel aggrieved let them apply under State law to have these log roads' income tax corrected. The remedy is open to them.

It is contended in the Atlantic Coast Line brief, p. 54, that the whole scheme of taxation in force in North Carolina is illegal and void because in conflict with the uniformity section of the State Constitution.

This is a very bold assertion, but suppose it were true, it would avail plaintiffs nothing as this Court has often said unless it deprived plaintiffs of some right guaranteed by the Federal Constitution and the said brief fails to point out any part of Federal Constitution that is violated.

But the assertion is without foundation. It is true that the State Constitution declares that "Laws shall be passed taxing by a uniform rule all moneys, credits, investments in bonds, stocks, joint stock companies, or otherwise, and also all real and personal property according to its true value in money."

That has been in the Constitution for fifty years. The income tax amendment was adopted in 1920 to that section.

That entire section, with all amendments to it, is set out on p. 31 of Norfolk Southern brief.

State Tax Commissioners, December 20, 1922, Clark C. J. alone dissenting, South Eastern Reporter, February 17, 1923, p. 336. In that case it is held:

The provision of Pub. Laws 1921, c. 34, § 4, that an individual stockholder shall not be required to list for taxation his stock, is not contrary to Const. art. 5, § 3, requiring laws to be passed for the uniform taxation of investments in stocks, in view of the provisions of Pub. Laws, 1921, c. 38, §§ 43, 57, 82, requiring the corporation to report to the Tax Commissioner all elements imparting value to its capital stock and tax such stock through the corporation.

A copy of the opinions in this case was sent to this Court as when the decision was announced last December.

In conclusion, I hope and believe that when Your Honors have given this case the examination you will give it, and which its great importance deserves, you will find no ground upon which to reverse the judgment of the District Court.

GEO. H. BROWN,
of Counsel for Defendants.

ATLANTIC COAST LINE RAILROAD COMPANY *v.*
DAUGHTON, COMMISSIONER OF REVENUE OF
THE STATE OF NORTH CAROLINA, ET AL.

NORFOLK SOUTHERN RAILROAD COMPANY *v.*
SAME.

SEABOARD AIR LINE RAILWAY COMPANY *v.*
SAME.

SOUTHERN RAILWAY COMPANY *v.* SAME.

APPEALS FROM THE DISTRICT COURT OF THE UNITED STATES
FOR THE EASTERN DISTRICT OF NORTH CAROLINA.

Nos. 724, 727, 744, 756. Argued April 25, 1923.—Decided June 4,
1923.

1. A State may, consistently with the Federal Constitution, impose a tax upon the net income of property, as distinguished from the net income of him who owns or operates it, although the property is used in interstate commerce. P. 420.
2. The Income Tax Law of North Carolina directs that the "net operating income" of railroads within the State be determined upon the basis of accounts to be kept according to the method established by the Interstate Commerce Commission, and lays a tax upon the "net income," to be ascertained by deducting from "net operating income" only uncollectible revenue, certain taxes, and amounts paid for car hire, thus treating the railroad property within the State as the thing of which the income is taxed, and taking no account of other income of the corporation owning the railroad and making no deduction of its capital charges. *Held*, That the statute, considering this distinction, does not in effect, depart from the Commission's definition of net income, nor, as applied to

interstate railroads, does it directly burden interstate commerce, or discriminate against it, (other public service corporations, wholly intrastate, being treated in the same way); nor does it, with other railroad taxes of the State, make an aggregate burden violating the commerce clause; nor does it violate that clause by departing from the standard form of accounts prescribed by the Interstate Commerce Commission under the Transportation Act, 1920. P. 421.

3. The above statute is not obnoxious to the equal protection clause, either in refusing to public service corporations, including railroads, deductions of interest on funded debt, rentals and worthless debts, which are allowed to other corporations and individuals in calculating net income, or in not requiring certain short line railroads to keep the accounts required of other railroads. P. 423.
4. The Constitution of North Carolina does not forbid taxing the net income of property operated as a railroad as distinguished from the net income of the company owning the railroad. P. 424.
5. The above cited statute does not violate the uniformity clause of the North Carolina Constitution, in that the permissible deductions in computing net income of public service corporations are different from, and not so great as, those allowed individuals or other corporations. *Id.*
6. The statute is not retroactive and void under the state constitution because it lays a tax based upon the net income of the calendar year within which it was enacted. P. 425.
7. A bill in the District Court, to enjoin the collection of state taxes alleged to be unconstitutional, will not be dismissed upon the ground that a plain, adequate and complete remedy exists, in paying the taxes under protest and suing to recover the amount paid, when the statute relied on as affording such remedy is recent and has not been construed and applied by the highest court of the State. P. 425.

Affirmed.

APPEALS from decrees of the District Court dismissing the bills, after hearing the merits, in four suits brought by railroad companies to enjoin the enforcement of a state income tax.

Mr. Thomas W. Davis, with whom *Mr. George B. Elliot* and *Mr. Harry Skinner* were on the brief, for appellant in No. 724.

Mr. George H. Brown and Mr. Wm. P. Bynum, with whom *Mr. James S. Manning*, Attorney General of the State of North Carolina, *Mr. Frank Nash*, *Mr. Locke Craig*, *Mr. Thomas D. Warren* and *Mr. Sidney S. Alderman* were on the briefs, for appellees.

Mr. W. B. Rodman for appellant in No. 727.

Mr. S. R. Prince, with whom *Mr. W. M. Hendren* and *Mr. L. E. Jeffries* were on the brief, for appellant in No. 756.

Mr. Murray Allen, *Mr. Forney Johnston* and *Mr. James F. Wright* filed a brief on behalf of appellant in No. 744.

MR. JUSTICE BRANDEIS delivered the opinion of the Court.

The Constitution of North Carolina (Article V, § 3, as amended January 7, 1921) authorizes the General Assembly to tax incomes at a rate not exceeding six per cent. The Income Tax Act of March 8, 1921 (Revenue Act, c. 34, Schedule D, §§ 100-904, as amended by c. 35, Public Laws 1921) laid upon corporations a tax equal to three per cent. of the entire net income as therein defined and upon individuals a progressive tax not exceeding that percentage. For the purpose of ascertaining the taxable income the statute divides taxpayers into three classes—individuals, ordinary corporations and public service corporations (including railroads). The statute, in terms, taxes only net income. For railroads and other public service corporations required to keep accounts according to the method established by the Interstate Commerce Commission, it makes those accounts the basis for determining the "net operating income" (§ 202 as amended); and it directs that, in order to ascertain the "net income," there shall be deducted from the net operating income (a) uncollectible revenue; (b) taxes for

the income year, other than income taxes, and war profits and excess profits taxes; (c) amounts paid for car hire. Whether the statute is unconstitutional, because it fails to include among the deductions from income allowed public service corporations the capital charges, including other rentals paid, is the main question for decision.

The first year's tax under the act was payable in 1922, with respect to the net income received during the calendar year 1921. To enjoin its enforcement these four corporations brought suit in the federal court for the Eastern District of North Carolina against the Commissioner of Revenue and others. Each plaintiff owns and operates a line of railroad within the State, and is an interstate carrier. Each assails the statute on the grounds that it violates the commerce clause, the Fourteenth Amendment and the state constitution; and only on these grounds. Each case was heard upon the merits. And in each a final decree was entered dismissing the bill. Appeals were taken under § 238 of the Judicial Code; and orders of the District Court stayed collection of the taxes pending the determination of the appeals. Since the cases are properly here on federal questions, all questions presented by the record whether involving federal law or state law must be considered. *Southern Ry. Co. v. Watts*, 260 U. S. 519.

It is conceded by appellants that taxation of the net income of an interstate carrier does not violate the commerce clause, *United States Glue Co. v. Oak Creek*, 247 U. S. 321; *Shaffer v. Carter*, 252 U. S. 37, 57; *Underwood Typewriter Co. v. Chamberlain*, 254 U. S. 113; and by the State, that taxation of gross receipts would be void as burdening interstate commerce. *Galveston, Harrisburg & San Antonio Ry. Co. v. Texas*, 210 U. S. 217. It is conceded by appellants that classification of public service corporations, and specifically of railroads, for purposes of taxation does not violate the Fourteenth Amend-

ment; *Bell's Gap R. R. Co. v. Pennsylvania*, 134 U. S. 232, 237; *Southern Ry. Co. v. Watts*, 260 U. S. 519; and by the State, that an arbitrary classification is obnoxious to the equal protection clause. *Southern Ry. Co. v. Greene*, 216 U. S. 400. The contentions are that the statute, in fact, taxes gross income; that the classification as made by it is unreasonable; and that for these, and other, reasons it violates both the federal and the state constitution. All the contentions are, in our opinion, unsound. To appreciate the objections urged, and to present the reasons for holding them groundless, it is necessary to show the incidence of the tax. This may be done by examining how the assessment of \$13,133.09 made upon the Seaboard Air Line, and here assailed, was calculated.

The Seaboard being an interstate carrier, the accounts were kept as required by the Interstate Commerce Commission. Interstate business was apportioned, as customary, according to mileage. The results of operations within the State calculated according to the statute were these:

Operating revenues	\$8, 457, 328. 52
Operating expenses	7, 308, 823. 29
Net operating income.....	\$1, 148, 505. 23
From the net operating income were deducted:	
Uncollectible revenue ...	\$6, 342. 31
Taxes paid.....	410, 043. 38
Car hire.....	294, 350. 02
Additional deductions.....	\$710, 735. 71
Net taxable income.....	\$437, 769. 52
Tax on \$437,769.52 at 3 per cent.	\$13,133.09.

Thus, about one-twentieth ($\frac{1}{20}$) of the operating revenues of the Seaboard was subjected to taxation. To this one-twentieth the 3 per cent. income tax was applied.

The tax assessed (\$13,133.09) is about one-six hundred and fiftieth ($\frac{1}{600}$) of the total operating revenues (\$8,457,328.52).

That the calculation is correct, in accordance with the statute, is not disputed. That is, the net income earned, in 1921, by the Seaboard's lines in North Carolina was as calculated \$437,769.52. The Seaboard insists that it had no net income taxable in North Carolina; but, on the contrary, a loss, of which \$254,290.22 was apportionable to North Carolina. The loss is figured in this way:

Net income as calculated	
under the statutes.....	\$437, 769. 52
Non-operating income—not	
taken into account under	
the statute ¹	539, 643. 30
	<hr/>
Total net income.....	\$977, 412. 82
From which deduct:	
Capital charges (including rents paid) not	
taken into account under the statute ² ..	1, 231, 703. 04
	<hr/>
Net loss or deficit.....	\$254, 290. 22 ³

¹ The items of the above non-operating income are these:

Dividend income.....	\$113, 350. 45
Income from funded securities....	97, 257. 47
Income from unfunded securities..	13, 781. 90
Income from lease of road.....	259, 525. 95
Joint facility rent income.....	12, 664. 17
Rent from work equipment.....	5, 047. 23
Rent from floating equipment....	18. 22
Rent from locomotives.....	6, 767. 21
Miscellaneous rent income.....	22, 387. 79
Misc. non-operating physical prop-	
erty.....	7, 685. 69
Miscellaneous income.....	1, 157. 22
	<hr/>
	\$539, 643. 30

Thus the State takes, as the entity to be taxed, the railroad property operated by the Seaboard within the State. Therefore, it takes, as the primary basis for the tax, only operating revenues; that is, the gross receipts from operating such property. The Seaboard, on the other hand, assumes, as the entity which should be taxed, the company in respect to its North Carolina interests. Therefore the Seaboard takes, as the primary basis for the tax, in addition to the operating revenues of the lines within the State, North Carolina's proportion of the non-operating income of the company derived from other property owned by it, wherever situated. For the Seaboard, like

² The items of the above capital charges are these:

Interest on funded debt.....	\$1, 179, 252. 20
Interest on unfunded debt.....	43, 823. 64
Annual allotment of discount on bonds	24, 494. 16
Rent of leased roads.....	10, 448. 12
Rents of joint facility.....	34, 480. 98
Rent of locomotives.....	19, 860. 91
Rent for floating equipment.....	2, 599. 96
Rent for working equipment.....	510. 24
Rents, miscellaneous	3, 194. 86
Income charges, miscellaneous....	685. 25

\$1, 231, 703. 04

If the above items were added the total would be \$1,319,350.32. There is apparently some error in the items which is not however material to the result.

³ For the Atlantic Coast Line the calculation in accordance with the statute shows a net income of \$1,389,565.25. According to the company's contention the net income was \$333,205.09.

For the Norfolk Southern the calculation in accordance with the statute, it is said, shows a net income of \$653,882.17. (The correct figures would seem to be \$603,003.51.) According to the company's contention there was a deficit of \$424,338.92.

For the Southern Railway the calculation in accordance with the statute shows a net income of \$2,384,068.71. According to the company's contention the net income on one calculation was \$554,724.41 and on another calculation was \$456,798.56.

most other railroad systems, is, to some extent, a holding company, as well as an operating company; and, as holding company, receives dividends from other concerns, interest on bonds of other concerns, and rental from property owned but not operated. As the State treats the operated property as the entity, it does not concern itself with interest charges and the rentals paid, just as it does not concern itself with a mortgage upon the real estate when it lays the *ad valorem* tax. On the other hand, as the Seaboard treats the company—the person—as the entity to be taxed, it undertakes to ascertain the net income of the company. This includes as gross income, a proportion of the receipts from property not within the State and includes among the deductions from the gross income of the company, the capital charges.

That a State may, consistently with the Federal Constitution, impose a tax upon the net income of property, as distinguished from the net income of him who owns or operates it, although the property is used in interstate commerce, was settled in *Shaffer v. Carter*, 252 U. S. 37, 44, 52. There an Oklahoma statute was sustained which laid the tax upon the net income of Oklahoma oil property owned by a citizen and resident of Illinois. The Federal Constitution which permits to be taxed the net income of property owned by an individual, although a citizen of another State, obviously does not preclude such a tax where the property is owned or operated by a corporation. It is a common provision in state income tax laws to tax the net income of property within the State which is owned, or operated, by non-residents.* The differences between the parties arise, in the main, not from differ-

* The Federal Government taxes the net income of property owned or business carried on within the United States by a citizen resident abroad. *DeGanay v. Lederer*, 250 U. S. 376. The New York income tax law involved in *Travis v. Yale & Towne Mfg. Co.*, 252 U. S. 60, 73, taxes the net income "from all property owned . . . by natural persons not residents of the state."

ence in the method of determining what is net income, but from difference as to what is the subject of the tax. In other words, they differ as to the thing of which the net income is to be ascertained. This will appear from an examination of the several grounds on which the validity of the statute is assailed.

First. The contention that the statute is obnoxious to the commerce clause rests upon the argument that the State's definition of net income differs from that adopted by the Interstate Commerce Commission; that the State is without power to depart from the Commission's definition so far as concerns interstate commerce; and that, since the statutory definition differs, the act is unconstitutional. A conclusive answer to that argument is found in the fact that the State adopts (without modification) the commission's definition for the net income of that which it taxes. For treating as the entity to be taxed, the railroad property operated by the company within the State, it appears that every item which the railroad claims the statute wrongly disallowed as a deduction is of such a character, that it is either clearly a capital charge (as distinguished from an operating charge) or reasonably may be deemed such as a matter of accounting.⁵ The question of law thus presented is not one which involves enquiry into the intricacies of railroad account-

⁵ To prove that the statute, in fact, taxes some part of the gross earnings, attention is called specifically to some minor items which the statute does not allow as deductions. But these stand in no different position than the major items—interest on funded debt and leased line rentals—discussed above. Prominent among these lesser items is "joint facility rents" which, in the case of the Seaboard, amounted net to \$21,816.81. Joint facility rents paid were \$34,480.98; those received (credited as non-operating income) were \$12,664.17. This is rental paid for railroad facilities—like tracks, terminals and roundhouses. They are needed by the carrier as a part of the plant and, not being owned, are rented from others. The fact that they are used jointly with others, is, of course, immaterial. This rent, like the rent of a leased line, is paid to secure control of the

ing. Under the commerce clause it is essential that a state tax shall not directly burden interstate commerce and that it shall not discriminate against interstate commerce. With these essentials the North Carolina act complies. It is not assessed on gross receipts.⁶ Compare *Peck & Co. v. Lowe*, 247 U. S. 165; *Pullman Co. v. Richardson*, 261 U. S. 330. It does not discriminate against interstate commerce. For the taxable net income of other public service corporations which are wholly intrastate is determined also without allowing capital charges as a deduction. That there is no basis for the claim that the commerce clause is violated by the burden resulting from the aggregate of the several North Carolina railroad taxes was settled in *Southern Ry. Co. v. Watts*, *supra*.

Another, and more technical, argument in support of the contention that the statute violates the commerce clause as applied to interstate carriers is based upon the cases which sustain the power of the Interstate Commerce Commission to prescribe a uniform system of accounting.⁷

property operated. Hire of freight cars might have been treated in the same way, but the State, for reasons satisfactory to it, permitted that financial charge to be deducted, and to that extent reduced the tax.

⁶The term "net income," in law or in economics, has not a rigid meaning. Every income tax act necessarily defines what is included in gross income; what deductions are to be made from the gross to ascertain net income; and what part, if any, of the net income, is exempt from taxation. These details are largely a matter of governmental policy. As to them States differ; and there is apt to be difference of view in the same States at different times; and at the same time a different definition of taxable net income for different classes of taxpayers. Obviously such differences in detail do not render obnoxious to the commerce clause a state income tax which is otherwise unobjectionable.

⁷*Kansas City Southern Ry. Co. v. United States*, 231 U. S. 423; *Interstate Commerce Commission v. Goodrich Transit Co.*, 224 U. S. 194. Also *Illinois Central R. R. Co. v. Interstate Commerce Commission*, 206 U. S. 441, 461, 462; *Union Pacific R. R. Co. v. United States*, 99 U. S. 402, 420, 427.

It is said that, since the statute in ascertaining net income purports to follow the standard form of accounts prescribed by the Interstate Commerce Commission, but in fact departs therefrom, the statute invades the province of Congress and conflicts with the policy expressed in Transportation Act, 1920. There is in fact no such divergence in the accounting. But if there had been, it would not follow that every departure from the Commission's standard classification would render unconstitutional a state income tax act. The function of determining whether a tax burdens interstate commerce was not conferred upon the Commission. Its sole function is the regulation of carriers. For this purpose it has been empowered by Congress to require of them a uniform system of accounting. The financial results of their operations as therein disclosed are useful for many purposes. But they are not made conclusive for all. Moreover, the Commission's standard form is not immutable. Railway accounting is in process of development.*

Second. The contention that the statute is obnoxious to the equal protection clause rests upon the argument that the State's definition of net income of public service corporations (including railroads) is arbitrary. It is alleged to be arbitrary because it allows to other corporations and to individuals, certain deductions which

* See *Groesbeck v. Duluth, South Shore & Atlantic Ry. Co.*, 250 U. S. 607, 614; 3 I. C. C. 289, 343. Power to prescribe a mandatory accounting system was first conferred upon the Commission by the Hepburn Act (June 29, 1906, c. 3591, § 7, 34 Stat. 584, 593). In 1888 a recommendatory classification of operating revenues, expenses and charges was issued by the Commission; and between that date and 1908 the form was revised from time to time. On June 1, 1908, the Commission ordered carriers to make reports in the form prescribed and furnished by the Commission. Thereafter changes continued to be made from time to time. A comprehensive and detailed classification of income accounts was issued effective July 1, 1912. This was superseded by the revised classification effective July 1, 1914, which is now in force.

are denied to public service corporations; namely, interest on funded debt, rentals, and certain worthless debts (§ 306, pars. 2, 3, 6 and 7). That the differentiation results from the difference in the subject of the tax and, hence, is not arbitrary has been pointed out above. But, in any event, the differentiation would not render the statute unconstitutional. The State might, consistently with the equal protection clause, have subjected only public service corporations to the income tax, or it might have laid upon them a higher income tax than upon others; as it laid upon railroads a higher franchise tax than it did upon other corporations. Compare *Southern Ry. Co. v. Watts*, 260 U. S. 519.

The classification is also assailed as arbitrary on the ground that § 202 defining net income applies only to corporations required to keep records "according to the standard classification of accounting of the Interstate Commerce Commission"; that there are in the State corporations which are not required by law to keep their accounts according to the Commission's form, but which own railroads of standard gauge operated by steam, and have obtained authority to act as limited common carriers. In support of this contention, two railroads with short lines are instanced. They are owned by lumber companies and are taxed, not as railroads, but as if part of the lumber corporation. So far as appears the North Carolina authorities might require them to file accounts according to the Commission's classification, if they deemed this advisable. But obviously the State might reasonably classify such railroads differently from ordinary carriers.

Third. The claim that the statute violates the state constitution rests mainly on the contention that the tax is not upon the net income.* As shown above, the assump-

* The provision is: "The general assembly may also tax . . . incomes provided the rate . . . shall not . . . exceed six per cent., and there . . . shall be allowed . . . deductions . . . so that only net incomes are taxed."

tion is erroneous. Only the net income of the property operated as a utility is taxed. There is nothing in the constitution of the State which precludes taxing the net income of the property so operated, as distinguished from the net income of the company. There is no inconsistency between §§ 101 and 202 of the statute. It would seem from the decisions of the Supreme Court of North Carolina that the uniformity clause applies to income taxation; but that court has repeatedly held that the uniformity clause does not prevent reasonable classification.¹⁰ The contention that the uniformity clause is violated because the permissible deductions in the case of public service corporations are different from (and not so great as), those allowed individuals or other corporations¹¹ is unfounded, for reasons stated above. So is the contention that the statute is retroactive and void, because it was not enacted until March, 1922, but lays a tax based upon the net income of the calendar year.

On behalf of the State it was urged that the bill was properly dismissed by the District Court because there is under the laws of North Carolina a plain, adequate, and

¹⁰ *Smith v. Wilkins*, 164 N. C. 135; *Caldwell Land & Lumber Co. v. Smith*, 151 N. C. 70; *Lacy v. Packing Co.*, 134 N. C. 567; *Gatlin v. Tarboro*, 78 N. C. 119. Compare *State v. Williams*, 158 N. C. 610; *State v. Moore*, 113 N. C. 697; *Worth v. Railroad*, 89 N. C. 291.

¹¹ Every corporation is allowed to deduct from gross income all operating expenses,—that is, the disbursements incident to the life and the conduct of its business. But the individual is not permitted to deduct from gross income any part of his living expenses (except so far as they may be covered by the exemption). Railroads and other public corporations are allowed to deduct, as an operating expense, the cost of tools and small equipment. Individuals and other corporations are not. Ordinary corporations and individuals are allowed to deduct rentals and interest paid. Compare the limited deduction for interest paid under the Federal Corporation Tax Act. *Anderson v. Forty-two Broadway Co.*, 239 U. S. 69; *New York, New Haven & Hartford R. R. Co. v. United States*, 269 Fed. 907.

complete remedy at law by which a taxpayer may recover the amount of an illegal tax paid by him under protest. Our attention has been called to several North Carolina cases and statutes bearing upon this contention. But the statute mainly relied upon is a recent one which appears not to have been construed and applied by the highest court of the State. In the absence of such decision, we cannot say the remedy at law is plain and adequate. *Dawson v. Kentucky Distilleries & Warehouse Co.*, 255 U. S. 288, 296; *Wallace v. Hines*, 253 U. S. 66, 68; *Shaffer v. Carter*, 252 U. S. 37, 47; *Union Pacific R. R. Co. v. Weld County*, 247 U. S. 282; *Davis v. Wakelee*, 156 U. S. 680, 688. We have therefore passed upon the merits.

Affirmed.

COLLINS v. LOISEL, UNITED STATES MARSHAL
FOR THE DISTRICT OF COLUMBIA